KING & SPALDING

Client Alert

Energy & Natural Resources Practice

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Dodd-Frank's Sweeping Disclosure Provision Targets Oil, Gas, and Mining Companies:

Public companies must disclose payments to the U.S. and foreign governments

UPDATE: Final rules delayed until at least August 2011

A sleeper provision in the 2,200 page Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") requires SEC-regulated oil, natural gas, and mining companies to disclose information related to payments made to foreign governments or the United States government in connection with activities that run the gamut from exploration and development to extraction, processing, and export.

Specifically, Section 1504 applies to "resource extraction issuers" that file Form 10-K, 20-F, or 40-F annual reports ("Issuers"), requiring them to disclose, in those annual reports and electronically, certain information regarding payments to either the U.S. government or a foreign government for the purpose of the commercial development of oil, gas, or minerals.

Section 1504 is best understood as an attempt to use the existing disclosure regime (the periodic reporting provisions of the Exchange Act) to accomplish a policy aim — namely, to "support the Federal Government's commitment to international transparency promotion efforts relating to the commercial development of oil, natural gas, or minerals."

The international transparency promotion efforts are those advocated by the Extractive Industries Transparency Initiative (the "EITI"). The EITI, the formation of which was announced in 2002 by then-U.K. Prime Minister Tony Blair, seeks to require disclosure by natural resources companies of certain payments in order to heighten public awareness, and promote more equitable dispersal, of resource extraction payments to the inhabitants of developing countries.

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What actions constitute commercial development by a resource extraction issuer?

A "resource extraction issuer" is broadly defined as a company that "engages in the commercial development of oil, natural gas, or minerals."

Section 1504 further defines "commercial development of oil, natural gas, or minerals" to encompass exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity.

What constitutes the "Federal Government" and a "foreign government"?

While Congress left undefined the term "Federal Government," the SEC proposes to clarify that the term means the United States Federal Government and not the states or other subnational governments in the United States. The treatment of payments to Native American Nations under the proposed rules is opaque. Will the Nations be treated like a non-U.S. national government, or differently, as domestic dependent nations to whom payments need not be reported?

A "foreign government" means a foreign government, a department, agency, or instrumentality of a foreign government, or a company owned by a foreign government. It is unclear whether the final definition of foreign government will include a foreign subnational government, such as a state, province, county, district, municipality, or territory.

Is a parent company required to disclose payments made by subsidiaries?

Payments made by the Issuer, a subsidiary, or an entity under the control of the Issuer are all subject to disclosure in the Issuer's annual report. An Issuer may be determined to control entities that are not consolidated subsidiaries, one example being an unconsolidated joint venture.

How broad are the payment disclosure provisions?

In a word, sweeping. The types of payments subject to these disclosure requirements include: taxes, royalties, fees (including license fees), production entitlements, bonuses, and other material benefits that are part of the commonly recognized revenue stream for the commercial development of oil, natural gas, and minerals. Section 1504 does provide that payment of a *de minimis* amount will not require disclosure.

The disclosures must not only be made in the Issuer's annual report, but must also be submitted to the SEC in an interactive data format whereby certain attributes are electronically "tagged". This information will be made publicly available on the SEC website. Payment attributes to be identified are:

- The total amounts 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 company that made the payments;
- The government that received the payments, and the country in which the government is located;
- The project of the company to which the payments relate; and
- Any other information that the SEC deems necessary or appropriate in the public interest or for the protection of investors.

It is significant that these financial disclosures require not only summaries of expenses on a country by country basis, but also disclosure of payments at a project level of detail. This requirement presents the real possibility that what is typically treated as confidential commercial information will be disclosed to competitors and the public at large, all in a data format that is easy to locate, manipulate, navigate, and mine for information.

Additionally, the interests of non-U.S. partners (both governmental and private) in resource extraction ventures may be directly affected. These partners may resist having heavily negotiated terms and previously confidential payments publicly disclosed. In some cases, such disclosures may breach confidentiality agreements or even violate foreign laws. One possible reaction of foreign governments and private companies may be to favor dealings with private U.S. companies that are not subject to these disclosure requirements.

Section 1504's relationship to the Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (the "FCPA") prohibits improper payments to foreign government officials to assist in obtaining or retaining business. Original versions of the bill tabled in the mid-1970s that would eventually become the FCPA (the "Foreign Payments Disclosure Act") included provisions requiring all U.S. companies to disclose any payment in excess of $1,000 to any foreign agent or consultant and any and all other payments made in connection with foreign government business.

Congress in the 1970s rejected these disclosure provisions and in doing so expressed a clear preference for prohibition-based restrictions on payments by businesses to foreign governments. As a result, while the FCPA limits the *types* of payments that public companies can make to foreign government officials, the FCPA does not require *legal* payments of any sort to be disclosed. Section 1504 represents a strong shift in policy, resulting in a hybrid prohibition- and disclosure-based scheme that governs payments to foreign governments for those reporting companies that engage in the commercial development of oil, natural gas, and minerals. It takes securities disclosure from the realm of protecting investors against economic risks considerably further in the direction of protecting them against "moral hazard."

While subject to further SEC interpretation, the Section potentially saddles affected companies not only with an additional bureaucratic overlay but also with massive paperwork requirements. The late Senator Proxmire, D-Wi., a leading proponent of the FCPA, colorfully concluded that the imposition of such disclosure requirements on such U.S. companies operating abroad would be akin to "swatting a fly with a bazooka."

When will the disclosure requirements take effect?

The Section 1504 requirements will take effect after the company's first full fiscal year following the promulgation of the final rules. Assuming the SEC adopts final rules in late 2011, the first reporting period will be for the company's fiscal year ending in or after late 2012.

What should I expect next?

The SEC proposed rules have generated significant public interest, so much so that the initial comment period was lengthened by 30 days and the timeframe for issuance of final rules has been delayed by at least four months. It is difficult to predict what, if any, changes the SEC will make to the final rules. Key terms such as "commercial development," "foreign government," and "project" are open to further interpretation by the SEC. In promulgating the final rules, the SEC is likely to consider the underlying policy goals of accountability, transparency, and public awareness, given the broad ambit of the enabling legislation.

It is also possible that the SEC's delay may be due partly to the administrative burden associated with implementing the Byzantine provisions of the Dodd-Frank Act, and may not simply reflect the SEC's efforts to give consideration to the concerns voiced by Issuers and others during the public comment period.

What are its likely ramifications?

King & Spalding will be working closely with our clients to review the final rules once they are published by the SEC. In the meantime, we recommend that companies with the potential to be affected by these rules work to review and solidify their compliance and recordkeeping procedures and practices. Companies should also take into account the possibility of legal, shareholder, and public relations issues associated with the disclosure of previously confidential payments. [1]

[1] See the authors' related article on Dodd-Frank's "conflict minerals" provision in Lexology, available at http://www.lexology.com/r.ashx?l=7FCWE9W