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Legal Update
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US SEC Adopts Final Rules for Payments by Resource Extraction Issuers

On June 27, 2016, the Securities and Exchange Commission (SEC) adopted final resource extraction issuer payment disclosure rules.[1] The SEC adopted these regulations in response to a mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added Section 13(q) to the Securities Exchange Act of 1934 (Exchange Act). Section 13(q) directed the SEC to issue rules requiring resource extraction issuers to include in an annual report information on 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. This is the second time that the SEC has adopted rules to implement Section 13(q) of the Exchange Act.

In August 2012, the SEC adopted resource extraction issuer payment disclosure rules, but those rules were vacated in July 2013 by the US District Court for the District of Columbia. In September 2015, the US District Court for the District of Massachusetts ordered the SEC to file an expedited schedule for promulgating final rules. The SEC proposed new resource extraction issuer payment disclosure rules in December 2015, and, adhering to the expedited schedule it filed with the court, the SEC adopted the final rules in June 2016.

The final rules require resource extraction issuers to disclose payments made to US federal or foreign governments for the commercial development of oil, natural gas or minerals. New Rule 13q-1 requires resource extraction issuers to file their payment information reports on Form SD. (Form SD is the same form currently used for conflict minerals reporting.) The specific disclosure requirements for resource extraction issuer payment disclosure, as well as key definitions, are set forth in new Item 2.01 of Form SD, titled "Resource Extraction Issuer Disclosure and Report."

Compliance Date

A resource extraction issuer will have to file a Form SD containing payment disclosure annually, not later than 150 days after the end of the issuer's fiscal year, but the SEC has provided a transition period for compliance. Resource extraction issuers will first need to comply with the final rules for fiscal years ending on or after September 30, 2018. This means that calendar-year companies impacted by the new rules will first need to comply by late May 2019.

Required Disclosure

Under Item 2.01 of Form SD, 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 amounts 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; and
- Subnational geographic location of the project.

Pursuant to Item 2.01 of Form SD, resource extraction issuers will have to provide a brief statement in the body of the form 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. Resource extraction issuer payment disclosure must be made at the "project" level. An activity or payment that does not fall within the categories specified in the final rules will nevertheless need to be disclosed if it is part of a plan or scheme to evade the required disclosure.

The payment information must be provided on a cash basis. The required resource extraction issuer payment disclosure does not have to be audited. Information that is disclosed pursuant to the rules will be "filed" rather than "furnished," making the disclosures subject to liability under Section 18 of the Exchange Act. Although filed, the information and documents filed 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.

Alternative Reporting Regimes

A resource extraction issuer may satisfy its 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 Rule 13q-1. 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 pursuant to a regime deemed substantially similar, 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 and describing how to publicly access the report in the alternative jurisdiction. The issuer must specify that the payment disclosure is included in an exhibit and state where the report was originally filed. 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. Project names may be presented in their original language in addition to the English translation.

Unless the SEC provides otherwise in an exemptive order, a resource extraction issuer may follow the submission deadline of the approved alternative jurisdiction if it files a notice on Form SD-N on or before the due date of its intent to file on such basis. If the issuer fails to file such notice or if it files the notice but does not file the alternative report within two business days of the alternative jurisdiction's deadline, it will not be allowed to rely on the alternative reporting rules in the following fiscal year.

On the same date that the SEC adopted the final resource extraction issuer payment disclosure rules, it adopted an order[2] recognizing 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 that the issuer complies with the 150-day deadline of the resource extraction issuer payment disclosure rules).

Reporting Persons

All resource extraction issuers will have to make the payment disclosures, without regard to whether they are domestic or foreign issuers. The new rules define "resource extraction issuer" as 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.

Resource extraction issuers must disclose payments made by a subsidiary or controlled entity as well as direct payments made by the issuer. An entity is "controlled" if the issuer consolidates the entity or proportionately consolidates an interest in an entity or operation under the accounting principles applicable to the financial statements included in the resource extraction issuer's periodic reports filed pursuant to the Exchange Act.

According to the adopting release, the SEC does not consider an issuer to be a resource extraction issuer if it merely provides products or services that support the exploration, extraction, processing or export of such resources, such as an oil field services issuer that manufactures drill bits or provides hardware to help companies explore and extract resources or that is engaged by an operator to provide hydraulic fracturing or drilling services. However, if the oil field 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.

Targeted Exemptions for Delayed Reporting

The final rules contain two targeted exemptions providing for delayed reporting in specified circumstances.

Exploratory Activity. The final rules permit resource extraction issuers to delay disclosing payment information related to exploratory activities until the Form SD that is filed for the fiscal year immediately following the fiscal year in which such 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 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 Form SD filing. If the acquired entity was required to comply with such resource extraction issuer payment disclosure prior to the acquisition, this delayed reporting exemption will not apply.

No Exemptions for Violations of Foreign Law or Categories of Issuers

All resource extraction issuers must publicly disclose the information required by Item 2.01 of Form SD. Except for the above-described targeted exemptions allowing for delayed disclosure, the rules do not contain any express exemptions, even in situations where public disclosure of the payment by the resource extraction issuer would violate the laws of a foreign jurisdiction. Instead, 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.

Similarly, there are no exemptions for categories of issuers that fall within the definition of resource extraction issuer. For example, there are no exemptions based on size, ownership, foreign private-issuer status or extent of business operations constituting commercial development of oil, natural gas or minerals.

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, which equals or exceeds $100,000 or its equivalent in the resource extraction issuer's reporting currency 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. Under the resource extraction issuer payment disclosure rules, a "project" means 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. The definition expressly allows agreements that are both operationally and geographically interconnected to be treated by the resource extraction issuer as a single project. An instruction to Item 2.01 of Form SD provides the following non-exclusive list of factors to consider when determining whether agreements are operationally and geographically interconnected to constitute a project:

- Whether the agreements relate to the same resource and the same or a contiguous part of a field, mineral district or other geographic area;

- Whether they are performed by shared key personnel or with shared equipment; and
- Whether they are part of the same operating budget.

Commercial development of oil, natural gas or minerals. As noted above, the 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.[3] This term plays a significant role in the 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. However, of these terms, the SEC has only defined export and extraction in the final rules.

Export. This term is defined for the purposes of the 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:

- 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 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 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 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.

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 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 to calculate currency conversion. 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 and specify 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 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. The adopting release made it clear that the SEC rejected the suggestion that issuers submit their annual reports to the SEC confidentially, with the SEC using those confidential submissions to produce an aggregated, anonymized compilation that would be made available to the public. While Rule 13q-1 permits the staff to determine the form, manner and timing of the compilation, it specifies that the staff may not make the information contained in such compilation anonymous, whether by redacting the names of the resource extraction issuers or otherwise.

Practical Considerations

SEC reporting companies involved in the oil, natural gas or mining industries, even if such activities are not the primary focus of their business, will need to carefully assess whether they may be subject to the new reporting obligations, particularly when they have foreign

or offshore operations. While reporting companies that are engaged in exploration or extraction of oil, natural gas or minerals pursuant to a lease, license or concession granted by a foreign government or the US federal government are the most likely to be subject to the resource extraction payment disclosure rules, companies engaged in related activities, such as processing (including midstream operations and the ownership of processing facilities) and exporting oil, gas and minerals, should carefully review the nature of such activities and the nature of any payments made to government entities.

Although there is a transition period before reporting is required, companies affected by the rules should realize that there may be considerable start-up time and expense required in order to be ready to comply by the required deadline. These could include IT consulting, establishing new reporting systems, training local personnel on tracking and 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.

Because the definition of "project" is determined based upon agreements that form the basis for payment liabilities with a government and are operationally or geographically interconnected, companies that fall within the definition of resource extraction issuer should begin considering which agreements will constitute a project at the drafting and negotiation stage. These determinations of which agreements will constitute a project will in turn determine the reporting units for which payments must be tracked and disclosed.

Resource extraction issuers should review existing agreements governing their projects to determine if any include confidentiality provisions that would be breached by the new rules. If there are any such provisions, it may be prudent for the issuer to use the time permitted by the extended compliance date to negotiate amendments to permit the disclosure required by the SEC's new rules or to seek waivers of such contractual provisions.

Companies that fall within the definition of resource extraction issuer should also begin a review of their systems and controls for financial accounting and financial reporting to determine what additional procedures and processes they may need in order to report the payments required to be disclosed. Additional disclosure controls and procedures may need to be implemented in order to track payments by subsidiaries and controlled joint ventures to governments and government-controlled entities, as well as to comply with the new XBRL reporting requirements.

For companies with existing procedures for tracking and recording subsidiaries' payments to foreign governments for Foreign Corrupt Practices Act purposes, 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 in order to capture and report the requisite payment data, then the lead time to be prepared to comply with the new disclosure requirements will be significantly longer.

To prepare for compliance, companies that will need to report resource extraction payments under the SEC's 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 has determined to be substantially similar, as discussed above under "Alternative Reporting Regimes."

Because Form SD is not part of an issuer's annual report on Form 10-K, quarterly report on Form 10-Q or periodic report on Form 8-K,[4] the resource extraction issuer payment disclosures will not be subject to certification by the chief executive officer and chief financial officer of the issuer.

Since the time the SEC originally adopted the resource extraction issuer payment disclosure rules that were subsequently vacated, other jurisdictions have adopted comparable payment disclosures rules. Nevertheless, it remains to be seen whether the recently adopted final rules will competitively damage public companies that are resource extraction issuers or result in greatly increased expenditures for them as a result of compliance costs and lost opportunities with host governments having non-disclosure laws.

Foreign issuers that are exempt from, or not subject to, the requirements of reporting under an alternative reporting regime will need to determine whether they are also exempt from reporting under the new resource extraction issuer payment disclosure rules. If they are not exempt from the final rules, they will need to determine whether to comply with the final rules or to seek an exemption from compliance with such rules as described above under "No Exemptions for Violations of Foreign Law or Categories of Issuers."

Resource extraction issuers should determine sooner rather than later whether compliance with the final rules will violate the laws of a foreign jurisdiction as the final rules do not provide an exemption in such a situation. If such an issuer finds that it has conflicting disclosure obligations, it should start seeking an exemption from the final rules as soon as possible so that it will still have plenty of time to plan for compliance if the request for an exemption is denied.

The resource extraction issuer payment disclosure rules have been subject to litigation from both ends of the political spectrum, with litigation challenging the SEC's initial rules followed by litigation demanding that the SEC adopt rules in accordance with the Dodd-Frank mandate. It is possible that there could be additional litigation. However, as discussed above, there are steps companies should be taking to prepare for disclosure. Therefore, resource extraction issuers should *not* count on litigation delaying or overturning this Dodd-Frank mandate; they should use the time available now to prepare for compliance.

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Endnotes

1. Available at https://www.sec.gov/rules/final/2016/34-78167.pdf.
2. Available at https://www.sec.gov/rules/other/2016/34-78169.pdf.
3. Section 13(q) of the Exchange Act defines "commercial development of oil, natural gas or minerals" as including 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.
4. Form 20-F, Form 40-F and Form 6-K, as applicable, in the case of foreign private issuers.

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