

The SEC Proposes New Disclosure Obligations for any “Resource Extraction Issuers” Making Payments to Governments

by William L. Tolbert, Elaine Wolff and Alexander J. May

On December 15, the Securities and Exchange Commission (the “SEC”) approved proposed rules (the “Release”) implementing Section 1504 of the Dodd-Frank Consumer Protection and Wall Street Reform Act (the “Act”) regarding disclosure of payments made by resource extraction issuers (“REI”) to governments. If adopted as proposed, issuers involved in resource extraction will be required to disclose in their first annual reports after the rules are adopted all payments made to a foreign or the U.S. government for the commercial development of oil, natural gas, or minerals. Comments on the Release are due by January 31, 2011.

Background

Consistent with the Act and as stated by the SEC, the purpose of the proposed rules is to promote transparency in payments rather than providing material information to investors. According to the Release, the legislative history of Section 1504 of the Act indicates that the Extractive Industries Transparency Initiative (the “EITI”)¹ was considered in connection with this new statutory provision. The EITI is a voluntary coalition of oil, natural gas, and mining companies, foreign governments, investor groups, and other international organizations dedicated to fostering and improving transparency and accountability in countries rich in oil, natural gas, and minerals through the publication and verification of company payments and government revenues from oil, natural gas, and mining.² The United States is

one of several countries that support the EITI. The EITI website states that “countries rich in natural resources such as oil, gas, and mining have tended to under-perform economically, have a higher incidence of conflict, and suffer from poor governance. These effects are not inevitable and it is hoped that by encouraging greater transparency in countries rich in these resources, some of the potential negative impacts can be mitigated.”³

Issuers subject to the proposed rules

Issuers will be subject to the rule if they:

- Meet the definition of a REI;
- Make “payments”, either directly or through a subsidiary or controlled company; and
- Payments are made to a “foreign government” or the U.S. federal government.

Defining “Resource Extraction Issuers”

The SEC has defined a “resource extraction issuer” as an issuer that is required to file an annual report with the SEC and engages in “the commercial development of oil, natural gas or minerals.” The phrase “commercial development of oil, natural gas or minerals” is meant to be inclusive rather than exclusive. As such, it includes issuers engaged in “activities of exploration, extraction, processing, export and other significant actions relating to oil, natural gas, minerals or the acquisition of a license for any such activity.” Commercial development need not be

the core of the issuer's business. This interpretation largely tracks the statutory definition as written by Congress.⁴ The proposed definition is intended to include activities that are directly related to the commercial development of oil, natural gas or minerals and not activities that are ancillary or preparatory to these activities. The manufacture of certain products used in the commercial development of oil, natural gas, or minerals, such as the manufacture of drill bits, or the transportation of the oil, natural gas or minerals are the type of activities that would be "ancillary or preparatory" and would not require disclosure under the proposed rules. However, the removal of impurities from natural gas/oil before they are put into a pipeline for transport is the type of activity that would require disclosure because of the importance of these activities to the commercial development of these materials.⁵

The SEC asked for comment as to whether smaller reporting companies should be exempted from the rules.⁶

Making "Payments"

The SEC has defined "payment" to mean a payment which is:

- Made to further the commercial development of oil, natural gas or minerals;
- Is not "de minimus"; and
- Includes taxes, royalty fees (such as license fees), production entitlements, bonuses and other material benefits that are determined to be part of the commonly recognized revenue stream for the commercial development thereof.

The inclusion of "other material benefits" is meant to capture additional types of transfers not specifically defined in the Act.

The SEC does not define "de minimus", but does not view it as a materiality standard. Although the SEC considers the term "de minimus" to be sufficiently clear enough as to not merit further definition,⁷ it is seeking comment on whether it should further define it or promulgate standards such as dollar amounts or percentages.⁸

In addition to its own payments, the REI must also disclose any payments made by a subsidiary or entity under its control. In this context, "control" is the touchstone as to whether disclosure is required. This is a facts and circumstances-based determination and each REI must make such a determination.⁹ As proposed, if a REI must provide consolidated financial statement information for the subsidiary or entity in the REI's financial statement, then that subsidiary or entity would be "controlled" by the REI.

Foreign and domestic governments

Lastly, the REI must make payments that are to a "foreign government" or the federal government. The SEC has defined "foreign government" as a foreign government, agency, instrumentality or a company owned by a foreign government. This specifically includes foreign subnational governments, such as states, municipalities, provinces, counties, districts or any other level. In addition, the REI must also disclose any payments made to the U.S. federal government, but not state governments.

Form of disclosure

If an issuer is subject to the rules, it would be required to disclose any payments made in the fiscal year to a foreign or to the U.S. federal government in its annual report. Disclosure would consist of the type and total amount of each payment made for each project relating to the commercial development of oil, natural gas or minerals as well as the type and total amounts made to each government. Disclosure would be made under a separate heading entitled "Payments Made by Resource Extraction Issuers." This section would direct the reader to the information required to be provided in the exhibits to the filing. In addition, a REI would be required to provide the payment information in exhibits to the filing in an interactive data format. For domestic issuers, the SEC has proposed new Item 105 of Regulation S-K to implement this disclosure, as well as New Item 4(c) of Form 10-K. For foreign private issuers that file annual reports on Forms 20-F and 40-F, the SEC has proposed to amend these forms.

The SEC has proposed to add two additional exhibits to be filed with each annual report, one in a text format and one in XBRL (eXtensible Business Reporting Language). Disclosure in the proposed exhibits regarding payments would include:

- Total amount of payments, by category;
- The currency made to make the payment;
- The financial period in which the payments were made;
- The business segment of the REI that made the payments;
- The government that received the payments and the country in which the government is located; and
- The project of the REI to which the payments relate.

Treatment under the securities laws

The information contained in the annual report and the interactive data formats, for the purposes of the securities laws, will be considered to be “furnished” rather than “filed.” As a result, REIs would not be subject to Section 18 liability under the Exchange Act. However, failure to furnish the information would subject the REI to liability under Sections 13(a) and 15(d) of the Exchange Act.

Proposed effective date

The final rules would become effective on the date on which the REI is required to submit an annual report relating to the issuer’s fiscal year that ends not earlier than one year after the date on which the SEC issues the final rules. Because the SEC must enact final rules at the latest by April 15, 2011, disclosure would be required in an issuer’s annual report relating to the fiscal year ending on or after April 15, 2012.

Conclusion

Any issuer involved in the oil, natural gas or minerals industry should take careful note of its operations in foreign countries and domestically and consider whether any payments made by a subsidiary or an entity under its control would subject it to the proposed new disclosure rules. Issuers should also review contracts to see if, as part of the contractual language, any amounts could be classified as being a “payment” that would require disclosure of payment information.

Endnotes

- ¹ See generally Extractive Industries Transparency Initiative, <http://eiti.org/>.
- ² E.g. EITI, Report of the Government of the Republic of Azerbaijan (Host Government) about Aggregated Receipts from the Extractive Industries (2010) available at <http://www.oilfund.az/en/account>.
- ³ EITI Benefits, <http://eiti.org/eiti/benefits>.
- ⁴ Act, § 1504(q)(1)(A).
- ⁵ Release, 14-15.
- ⁶ See Release, page 12, cmt. 1.
- ⁷ The SEC specifically noted that de minimus has been defined as something that is “lacking significance or importance” or “so minor as to merit disregard.” Release at 27.
- ⁸ See Release, 27-28.
- ⁹ For example, the SEC cited Exchange Act Rule 12b-2’s definition of “control” as being potentially determinative. Release, 37. Rule 12b-2 defines “control” “as mean[ing] the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R. § 240.12b-2.

For more information, please contact the following Jenner & Block attorneys:

William L. Tolbert

Partner, Corporate Practice
Tel: 202 639-6038
Email: wtolbert@jenner.com

Elaine Wolff

Partner, Corporate Practice
Tel: 202 637-6389
Email: ewolff@jenner.com