SEC Re-Proposes Rules Implementing Dodd-Frank Disclosure Requirements for Resource Extraction Issuers

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On December 11, the SEC once again proposed rules to implement Section 1504 of the Dodd-Frank Act relating to resource extraction issuers. Section 1504 generally provides that a U.S. or foreign company that (1) files an annual report with the SEC and (2) engages in the commercial development of oil, natural gas or minerals, is required to disclose the type and total amount of payments made by the company to a foreign government or the U.S. federal government for each project. The **proposing release** concedes that the point of the rules is not investor protection; rather, the legislation is "intended to help combat corruption by increasing public transparency of resource extraction payments and, in so doing, to potentially enhance accountability and governance in resource-rich developing countries."

The new proposal revises a previous version of the rules adopted by the SEC in 2012 (discussed in our client memorandum available **here**), which were challenged by industry groups and ultimately vacated by a federal district court in 2013 and remanded to the SEC. The court found that the SEC misread the statute to require *public* disclosure of the information submitted under the statute and that the SEC's denial of an express exemption for disclosures prohibited under foreign law was arbitrary and capricious. The SEC declined to appeal the ruling and subsequently re-wrote the rules.

Unfortunately, the revised rule proposal is broadly similar to the original rulemaking with fairly minor changes that give a slight nod to the legal challenges raised in the court's decision. Specifically, the re-proposed rules continue to require *public* disclosure (rather than confidential submission) of resource extraction payment information and do not provide a blanket exemption for disclosures prohibited under foreign law (or for any other reason)—both grounds on which the court invalidated the prior rules. Instead, the newly proposed rules would allow companies to apply for exemptive relief on a case-by-case basis, tailored to their individual facts and circumstances. Other changes reflect the growing global momentum to improve transparency in the extractive industries, particularly in the European Union and Canada, which recently adopted resource extraction payment disclosure laws largely based on the SEC's vacated rules. In line with the European Union and Canadian reporting regimes, the newly proposed rules would permit companies to satisfy their SEC disclosure obligations by using disclosures prepared for other jurisdictions, provided those jurisdictions have rules substantially similar to the SEC's own rules.

In an unusual departure from typical agency procedure, the revised rule proposal has a two-phase comment process. Initial comments are due by January 25, 2016, and reply comments (which may respond only to issues raised during the initial comment period) are due by February 16, 2016. In developing the final rules, the SEC may rely on both new comments and comments that were received in connection with the original rulemaking. Pursuant to an expedited rulemaking schedule filed with the court, the SEC has proposed to vote on the adoption of final rules by June 27, 2016. This deadline was heavily caveated, however, and the SEC warned the projected timetable was extremely aggressive and might not be met. Final rules, once adopted, may face continued legal challenges, which may benefit from the SEC's relatively minor modifications in response to the previous legal challenges.

Covered Entities

Under the proposed rules, the term "resource extraction issuer" would apply to U.S. and foreign companies that (1) file an annual report with the SEC pursuant to Section 13 or 15(d) of the Exchange Act (i.e., a Form 10-K, 20-F or 40-F) and (2) engage in the commercial development of oil, natural gas or minerals, regardless of the extent of such commercial development operations. Registered investment

companies would not be subject to the proposed rules, but emerging growth companies, smaller reporting companies and government-owned companies would be covered. Interpretive guidance issued by the SEC staff in connection with the prior rules clarified that Exchange Act reporting companies that are not engaged in commercial development activities themselves but whose subsidiaries or other entities under their control engage in those activities would be considered resource extraction issuers and thus would be subject to the proposed disclosure requirements. We would expect this guidance to remain applicable under the newly proposed rules.

Covered Activities

The proposed rules would define "commercial development of oil, natural gas or minerals" to include exploration, extraction, processing, export and the acquisition of a license for any such activity. The proposing release indicates that this definition comprises activities similar to those covered by the resource extraction payment disclosure regimes of Canada and the European Union and thus is consistent with the congressional mandate for the SEC's rules to support international transparency promotion efforts.

The proposed definition of "commercial development" is intended to capture only activities that are *directly related* to the commercial development of oil, natural gas or minerals, and is not intended to capture activities that are ancillary or preparatory to such commercial development. Accordingly, a company that provides only services associated with or in support of the exploration, extraction, processing or export of such resources (e.g., hydraulic fracturing or drilling services) or that provides hardware to help companies explore or extract would not be considered a resource extraction issuer. Marketing activities and activities relating to security support would similarly be excluded.

The proposing release identifies specific activities that would be covered by the terms "extraction" and "export" and provides examples of the activities that would constitute "processing," although it emphasizes that, in all cases, whether a company is a resource extraction issuer would depend on the specific facts and circumstances. "Extraction" would mean the production of oil and natural gas as well as the extraction of minerals. "Processing" would include, but not be limited to, midstream activities such as the processing of gas to remove liquid hydrocarbons and the removal of impurities from natural gas prior to its transport through a pipeline. It would also include the crushing and processing of raw ore prior to the smelting phase. It would not include the downstream activities of refining or smelting.

In addition, the proposed rules would draw a distinction between export and transportation. "Export" would mean the movement of a resource from its country of origin to another country by an issuer with an ownership interest in the resource. By contrast, cross-border transportation activities by an issuer that is functioning solely as a service provider, with no ownership interest in the resource being transported, would not be considered to be export.

Covered Payments

A company subject to the proposed rules would be required to disclose the total amount of payments to a foreign national or subnational (e.g., district, county or provincial) government or the U.S. federal government for each project made to further the commercial development of oil, natural gas or minerals. State-owned enterprises that are at least majority-owned by foreign governments are deemed to be foreign governments, so payments of the types identified in the proposed rules to such enterprises would need to be disclosed.

A resource extraction issuer 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 or proportionately consolidated under the accounting principles applicable to the issuer's financial statements included in its Exchange Act reports.

The proposed rules would include an exception for *de minimis* payments, which are payments less than $100,000 (or the equivalent in the issuer's reporting currency) during the same fiscal year, whether made as a single payment or a series of related payments, which the SEC notes is consistent with the developing international consensus for payment reporting thresholds.

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

- taxes;
- royalties;
- fees;
- production entitlements;
- bonuses;
- dividends; and
- payments for infrastructure improvements (e.g., building a road).

The proposing release indicates that this list of payment types is consistent with the payments identified in the resource extraction payment disclosure regimes of the European Union and other jurisdictions. The SEC has followed the approach of the European Union and Canada in not proposing to require the disclosure of social or community payments (e.g., payments to build a hospital or school).

With respect to taxes, payments for taxes levied on corporate profits, corporate income and production would be required to be disclosed. However, payments for taxes levied on consumption, such as value-added taxes, personal income taxes or sales taxes, would not have to be disclosed. Fees would include license fees, rental fees, entry fees and concession fees. Bonuses would include signature, discovery and production bonuses. Dividends paid to a government in lieu of production entitlements or royalties would be required to be disclosed. However, disclosure of dividends paid to a government as a common or ordinary shareholder of the issuer that are paid to the government under the same terms as other shareholders would not be required.

The proposed rules also would require resource extraction issuers to disclose payments made in-kind, and to determine the monetary value of any such in-kind payments. The proposed rules specify that issuers may report in-kind payments at cost or, if cost is not determinable, fair market value, and should provide a brief description of how the monetary value was calculated.

Anti-Evasion Provision

The proposed rules would include an anti-evasion provision that requires disclosure with respect to an activity or payment that, although not in form or characterization within one of the categories of activities or payments specified under the proposed rules, is part of a plan or scheme to avoid or obfuscate the statutory disclosure requirements.

Form SD Requirements

For any payment required to be disclosed, the proposed rules would require a resource extraction issuer to provide the following information in an XBRL exhibit to Form SD using electronic tags:

- the type and total amount of payments made for each project;
- the type and total amount of payments for all projects made to each government;
- the total amounts of the payments, by category (e.g., taxes, fees or bonuses);
- the currency used to make the payments;

- the financial period in which the payments were made;
- the business segment of the resource extraction issuer that made the payments;
- the government that received the payments, and the country in which the government is located;
- the specific project to which the payments relate;
- the particular resource that is the subject of commercial development; and
- the subnational geographic location of each project.

When payments are made in multiple currencies, resource extraction issuers would be required to report the total amount of payments in one currency—either U.S. dollars or the issuer's reporting currency if not U.S. dollars. The proposed rules would provide several options for calculating the currency conversion between the currency in which the payment was made and U.S. dollars (or the issuer's reporting currency), and an issuer would have to disclose the method used to perform the currency conversion.

"Business segment" would be defined consistent with the reportable segments used by resource extraction issuers for purposes of financial reporting, which the proposing release suggests would enable issuers to report the information according to how they currently report their business operations.

For purposes of identifying the subnational geographic location of the project, the proposed rules would require that resource extraction issuers provide information regarding the location of the project that is sufficiently detailed to permit a "reasonable user of the information" to identify the project's specific, subnational geographic location. The proposing release notes that in considering the appropriate level of detail, issuers may need to consider how the relevant contract identifies the location of the project.

The proposed rules would not require the resource extraction payment information to be audited or provided on an accrual basis.

Project-Level Reporting

The proposed rules would require that payments be reported on a project-level basis, which reflects the SEC's belief that detailed, disaggregated, project-level revenue data provides greater transparency to local communities that may seek to verify they are receiving payments to which they are entitled.

The proposed rules would define "project" to mean the operational activities governed by a single contract, license, lease, concession or similar legal agreement, which form the basis for payment liabilities with a government. Resource extraction issuers would be allowed to treat multiple agreements that are both operationally and geographically interconnected as a single project. In order to assist resource extraction issuers in determining whether two or more agreements may be treated as a single project, the proposed rules would include an instruction to Form SD that provides a non-exclusive list of factors to consider when determining whether agreements are "operationally and geographically interconnected" for purposes of the definition of "project." These factors include whether the agreements relate to the same resource and the same geographic area, whether they will be performed by shared key personnel or with shared equipment and whether they are part of the same operating budget.

In the proposing release, the SEC acknowledges the potential competitive concerns resulting from its proposed definition of "project," which would require the public disclosure of contract-level data. Despite this acknowledgment, and despite the fact that the court specifically instructed the SEC to consider that the legislation does not require public disclosure of information about resource extraction payments, the SEC nonetheless has proposed to make this information public.

Public Disclosure

Consistent with the original rules, the re-proposed rules would require public disclosure (rather than confidential submission) of resource extraction payment information, including the identity of the issuer. In

vacating the original rules, the court held that the statute grants the SEC discretion to determine whether the mandated disclosures should be publicly filed or provided confidentially only to the SEC. The SEC contends that public disclosure best serves the anticorruption, transparency and accountability objectives that Congress intended when it enacted the statute, including consistency with international transparency promotion efforts such as the European Union and Canadian rules, and that permitting issuers to submit the required payment information confidentially would not support, and actually could undercut, that statutory purpose. Notably, the SEC argues that, despite the court decision, neither the statute's text nor legislative history includes any suggestion that the mandated disclosures should be confidential. In fact, the SEC believes the text, structure and legislative history of the statute confirm its view that the information submitted under the statute should be publicly disclosed.

Tailored Exemptions

Like the original rulemaking, the SEC has proposed not to adopt a blanket exemption in the event of disclosures prohibited under foreign law (or for any other reason). In a change from the prior rules, however, resource extraction issuers could apply for, and the SEC would consider, individualized exemptive relief, if and when warranted.

The SEC explains that it believes a case-by-case approach to exemptive relief using its existing Exchange Act authority is preferable to either adopting a blanket exemption for a foreign law prohibition or providing no exemptions and no avenue for exemptive relief. It maintains that this approach would permit it to tailor the exemptive relief to the particular facts and circumstances presented (for example, by permitting alternative disclosure or phasing out the exemption over an appropriate period of time).

The SEC notes that a blanket exemption could create a stronger incentive for host countries that want to prevent transparency to pass laws that prohibit such disclosure, potentially undermining the purpose of the rules to compel disclosure in foreign countries that have failed to voluntarily do so. A blanket exemption, in its view, could also remove any incentive for issuers to diligently negotiate with host countries for permission to make the required disclosures. The SEC suggests that, by contrast, a more flexible and targeted, case-by-case exemptive approach could improve the comparability of payment information among resource extraction issuers and across countries. The proposing release indicates that this approach is consistent with the recently implemented resource extraction payment disclosure regimes in Canada and the European Union.

An issuer seeking exemptive relief would need to submit a written request describing the disclosures it seeks to omit and the specific facts and circumstances that warrant an exemption, including the particular costs and burdens it faces if it discloses the information. Any requests for exemptive relief based on disclosure prohibitions under foreign law would require an opinion of counsel. Other criteria the SEC would consider in making a determination whether to grant an exemption include whether the disclosure is already publicly available and whether (and how frequently) similar information has been disclosed by other companies. The proposing release notes that if an issuer is already making the disclosure under another regulatory disclosure regime, it would likely have a heavy burden to demonstrate that an exemption is necessary. The SEC would generally expect to make any requests for exemptive relief public and to provide an opportunity for public comment.

The commentary in the proposing release suggests that the SEC will be parsimonious in granting such exemptions, which companies could find very troubling, particularly in the case of foreign law prohibitions where the lack of exemptive relief could lead to conflicts between two legal regimes.

Alternative Reporting

In a change from the original rulemaking, the proposed rules would allow resource extraction issuers to satisfy their SEC disclosure obligations by using a report originally prepared for foreign regulatory purposes or for the U.S. Extractive Industries Transparency Initiative (USEITI), provided the SEC deems

the alternative reporting requirements to be substantially similar to its own rules. The USEITI is a multilateral transparency initiative under which the United States is currently a candidate country.

The SEC states that it made this change in light of international developments since the original rules were vacated, including the enactment in the European Union and Canada of mandatory resource extraction payment disclosure regimes (neither of which was in place when the original rules were adopted), the United States' becoming an EITI candidate country and the increased momentum generally of multilateral efforts to promote extractive industries transparency.

Among the criteria the SEC would consider in making a determination whether the alternative disclosure requirements are substantially similar to its own rules are the types of activities that trigger disclosure; the types of payments that are required to be disclosed; whether project-level disclosure is required and, if so, the definition of "project"; whether the disclosure must be publicly filed and whether it includes the identity of the issuer; whether the disclosure must be provided using an interactive data format that includes electronic tags; and whether any exemptions are allowed (and any conditions limiting such exemptions).

Timing and Effective Date

The proposed rules would require a resource extraction issuer to file its payment disclosure annually on Form SD (currently used to file conflict minerals reports), on EDGAR, no later than 150 days after the end of its fiscal year, starting with the fiscal year ending no earlier than one year after the effective date of the adopted rules. For example, if the final rule is adopted in June 2016 (in keeping with the current rulemaking timetable), calendar year-end companies would file their first reports for the 2017 reporting period by May 2018. Form SD would require resource extraction issuers to include a brief statement directing users to detailed payment information provided in an exhibit, which would be subject to XBRL tagging.

Disclosure Liability

The resource extraction payment disclosure provided on Form SD would be considered "filed" with the SEC rather than "furnished." Accordingly, any materially "false or misleading statement" in the disclosure would be subject to liability under Section 18 of the Exchange Act. Section 18 provides for a private right of action to investors who can prove they were harmed by relying on the misstatement. Section 18, however, does not create strict liability for filed information and provides that a company will not be liable for misstatements in a filed document if it can establish that it "acted in good faith and had no knowledge that such statement was false or misleading." Issuers also would be subject to potential liability under Exchange Act Section 10(b) and Rule 10b-5 thereunder for any false or misleading material statements in the filed disclosure. Because Form SD is separate from a company's Exchange Act annual report, the filed disclosure would not be covered by the report's CEO and CFO certifications or automatically incorporated into a company's Securities Act or Exchange Act filings.

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

Alan F. Denenberg	**650 752 2004**	**alan.denenberg@davispolk.com**
Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
Byron B. Rooney	**212 450 4658**	**byron.rooney@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**
Michele Luburich	**212 450 4172**	**michele.luburich@davispolk.com**