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The SEC's New Resource Extraction Issuer Rules – Broad, Vague, Costly, Anti-competitive, and Requiring Immediate Action

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Introduction. On August 22, 2012, the Securities and Exchange Commission adopted new rules imposing significant new disclosure obligations on resource extraction issuers ("REIs"). The rules, which implement Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, require REIs to disclose payments made to the U.S. federal government and all foreign governments for the purpose of the commercial development of oil, natural gas or minerals. The disclosures must be filed annually on Form SD within 150 days after the end of each fiscal year ending after September 30, 2013.

The new rules closely follow Section 1504 and the SEC's proposed rules, and the SEC largely rejected requests to clarify and narrow the scope of the rules. As a consequence, the rules are extremely broad and, unless clarified or narrowed through further legislative or regulatory action, seemingly apply to a wide array of commercial arrangements and to many public companies beyond traditional E&P companies, including midstream companies engaged in treating or processing and companies engaged in the exportation of oil, natural gas and minerals, such as commodities traders, LNG exporters and crude oil and LNG shipping companies.

As a consequence, any public company operating in the energy industry or engaged in commodity trading should review its activities in light of the new rules to determine whether the rules apply to it.

***Resource Extraction Issuer*.** The rules define an REI as a company required to file an annual report with the SEC which is engaged in the commercial development of oil, natural gas or minerals. The rules are not limited to companies operating internationally and provide no exceptions for small issuers or for issuers whose resource extraction activities are insignificant.

The "commercial development of oil, natural gas or minerals" includes the activities of exploration, extraction, processing and exportation of oil, natural gas or minerals or the acquisition of a license for any such activity. The SEC indicated in the adopting release that a company only needs to engage in one of the enumerated activities to be an REI.

The rules and examples in the adopting release provide guidance in identifying activities that constitute "commercial development of oil, natural gas or minerals" and include the following:

- traditional oil and natural gas exploration and production activities;
- extraction of minerals;
- field processing, including the processing of natural gas to extract liquid hydrocarbons, the treatment of natural gas to remove impurities prior to transport and the upgrading of bitumen and heavy oil;
- crushing and processing of raw ore prior to smelting; and
- export of oil, natural gas or minerals from the host country.

The SEC stated in the adopting release that the following types of activities do not constitute commercial development of oil, natural gas or minerals:

- the manufacture and sale of a product used in the commercial development of oil, natural gas or minerals;
- oil refining and smelting;
- transportation other than for the purpose of or directly related to the export of oil, natural gas or minerals, such as transporting a resource to a refinery or smelter or to a storage facility prior to exporting it; and
- storage and marketing of oil, natural gas or minerals.

While REIs will primarily include companies with oil and natural gas exploration and production activities, mining companies and midstream energy companies that provide processing and treating services, the scope of the rule has the potential to apply to a broader group of companies, including public companies engaged in the exportation of oil, natural gas and minerals, such as commodities traders, LNG exporters and crude oil and LNG shipping companies. The rules and adopting release are silent on their applicability to oilfield service companies. While the rules appear not to apply to service companies, which typically act on a contract basis for E&P companies, the rules expressly include processing, which is frequently provided on a contract basis to an E&P company by a midstream company. The statute and rules lack a consistent approach to defining the nature of a company's required relationship to the underlying commodity in order to be an REI, which adds uncertainty to the status of midstream companies, service companies, exporters and others whose activities are tangential to the E&P function. We suspect that most service companies will conclude that the rules do not apply to them, but SEC clarification of this point would be helpful. On the other hand, midstream companies engaged solely in the transportation of hydrocarbons, other than for the purpose of or directly related to exportation, and downstream companies whose activities are limited to refining and marketing should not be viewed as REIs.

***Payments to be Disclosed*.** A "payment" covered by the rules includes any payment that is made to the U.S. federal government or a foreign government (a) to further the commercial development of oil, natural gas or minerals, (b) that is not *de minimis* and (c) is of one of the following types:

- taxes, including entity-level taxes on corporate profits, corporate income or production (but not value added taxes or sales taxes);
- royalties;
- fees, including license, rental, entry and concession fees;
- production entitlements;
- bonuses, including signature, discovery and production bonuses;
- dividends paid to governments in lieu of production entitlements or royalties (but not dividends paid on the same terms as dividends paid to common or ordinary shareholders); and
- payments for infrastructure improvement, such as for the construction of a road to be used by the REI for the commercial development of oil, natural gas or minerals (but not "social payments" or "community payments," such as for a local school or hospital).

The rules define "not *de minimis*" as any payment or series of related payments that equals or exceeds $100,000.

Several commenters during the rulemaking process asked the SEC to exclude taxes of general applicability, such as U.S. federal income taxes, from the definition of "payment." The SEC declined to do so and, as a consequence, an REI's payments to the U.S. federal government or a foreign government of taxes of general applicability appear to constitute "payments" under the rules. Under the rules, a payment must be made in furtherance of the commercial development of oil, natural gas or minerals in order to be subject to disclosure. REIs with limited commercial development activities, such as large financial companies with commodities trading operations, may determine that taxes of general applicability, such as U.S. corporate income taxes, are not disclosable because little of such REI's income relates to such commercial development activities. REIs with more extensive energy operations, however, may have a difficult time reaching this conclusion. Further guidance from the SEC in this area would be helpful.

As discussed more fully below, the rules define a foreign government to include a company that is majority-owned by a foreign government (an "NOC"). As a result, payments of the types included in the list above made by an REI to an NOC will be subject to disclosure under the rules. Thus, an E&P company operating in the U.S. that has an NOC as a JV partner will be required to disclose, in addition to its federal income taxes, payments of the type enumerated above to its NOC JV partner.

Companies that constitute REIs will need to closely scrutinize the types of payments they make and implement measures to identify, track and record such payments for disclosure. Companies operating internationally will likely encounter many of the types of payments in the list of payment types. Public companies operating inside the U.S. who partner with NOCs or sovereign wealth funds will also likely encounter many of such payments. Such companies will also need to consider whether payments for infrastructure improvement extend to the development of gathering systems and other infrastructure typically funded proportionately by JV partners in connection with the development of a field in the U.S. E&P companies operating

in the U.S. on federal lands and in federal waters will need to identify and track the payments that they make related to those activities (e.g., bonuses and royalty payments). Likewise, midstream companies with treating or processing plants on federal land or on platforms in federal waters will need to identify and track the payments that they make related to those activities (e.g., rental payments).

No Exemptions Under Foreign Law or Confidentiality Provisions of Contract. The SEC declined to allow REIs to omit the disclosure of payments prohibited from disclosure under foreign law. Several commenters during the rulemaking process pointed out that Cameroon, China, Qatar and Angola have laws that may limit or prohibit the disclosures required by the rules. REIs should review their current activities in these and other countries in light of their disclosure obligations under the rules and may wish to seek formal opinions of local counsel as to whether making the disclosures required by the rules will violate applicable local law and the consequences thereof.

The SEC also declined to allow REIs to omit the disclosure of payments if such disclosure would violate the confidentiality provisions of a contract. REIs should review existing agreements and consider appropriate steps under any contracts containing confidentiality provisions, including whether to seek waivers or amendments under such contracts.

Foreign Governments and the Federal Government. The rules define a "foreign government" as a foreign government, a department, agency or instrumentality of a foreign government, a foreign subnational government, such as the government of a state, province or district, or a company owned by a foreign government. A company is considered owned by a foreign government if it is at least majority-owned by a foreign government. As discussed above, in addition to requiring disclosure of payments to an NOC related to projects in the NOC's home country, the rules may also require REIs to disclose payments made to NOCs in routine transactions outside its home country, including those relating to the development of properties in the U.S. where the NOC is essentially functioning as a financial investor. In short, commercial details of many projects involving NOCs may be subject to public disclosure under the rules.

In the U.S., the rules only include payments to the U.S. federal government, and do not require disclosure of payments made to U.S. state or local governments.

Subsidiaries and Entities under the Control of an Issuer. Adding further significant complexity and reach to the rules is the requirement that an REI must disclose payments made by the REI, a subsidiary of the REI or an entity under the control of the REI. The rules define "control" and "subsidiary" by reference to Rule 12b-2 under the Securities Exchange Act of 1934 (the "Exchange Act"). REIs that conduct activities through JVs and equity investees will be required to evaluate and conclude whether a control relationship exists based on all the facts and circumstances of the relationship. Many large E&P projects are undertaken through JV arrangements, and REIs will be required to examine the governance structure of each such arrangement to determine whether a control relationship exists. Such a determination can be time consuming and factually intensive depending on the governance structure and the presence or absence of contractual rights, such as negative control rights. Additionally, REIs will be required to grapple with the complexity of identifying and tracking payments made by less than wholly-owned entities where the other owners may not be subject to the rules.

***Projects*.** Disclosure of payments is generally required to be made at the project level. The rules do not define "project," and the SEC stated in the adopting release that it regarded the absence of a definition as providing issuers the flexibility to apply the term to different business contexts depending on factors such as the issuer's industry, business and size. The SEC also stated that the term "project" is generally understood by issuers and investors and pointed out that a "project" could be defined by reference to a specific contract relating to the commercial development of oil, natural gas or minerals.

The rules also provide that, if a government levies a payment, such as a tax or dividend, at the entity level rather than in relation to a particular project, an REI may disclose that payment at the entity level.

***Disclosure Required*.** The rules require disclosure of required payments on a new Form SD which must be filed 150 days after the end of the REI's fiscal year. An REI must file the following information in an exhibit to Form SD electronically formatted using the XBRL interactive data standard (with tags):

- The type and total amount of payments made for each project of the REI relating to the commercial development of oil, natural gas or minerals;
- The type and total amount of the payments made to each government;
- The total amounts of the payments, by payment type;
- The currency used to make each 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.

In the release adopting the rules, the SEC stated that reporting by business segment in Form SD should be consistent with the reportable segments used by the REI for purposes of financial reporting. The rules do not require payment information to be audited or provided on an accrual basis.

Costs. The SEC estimated that the new rules would apply to more than 1,100 issuers and that the initial compliance costs could exceed $1 billion, while ongoing compliance costs could reach $400 million annually. The SEC acknowledged that more than 50 issuers with operations in Angola, Cameroon, China and Qatar may have to withdraw from those countries thereby incurring additional costs in the billions of dollars and significantly impacting their profitability and competitive position.

Liability. A materially "false or misleading statement" in Form SD will be subject to liability under Section 18 of the Exchange Act. Information included in Form SD will not be deemed to

be incorporated by reference into any other documents (such as a shelf registration statement) filed with the SEC unless the issuer specifically provides otherwise. Certifications by an issuer's principal executive and financial officers will not apply to Form SD.

Conclusion. The payment identification, tracking and disclosure obligations imposed by the rules create a significant new burden on REIs. Moreover, this obligation will extend, not just to multinational oil and gas companies, but will also extend to many other participants in the energy industry. Affected issuers will likely need considerable time to organize their data collection processes to collect the information required to comply with the rules. Affected issuers should also begin to review the impact of the new rules under foreign law and under the issuer's contractual relationships. In recognition of the time REIs will need to effect changes in their reporting systems in order to comply with the rules, the first required report for most companies may be limited to information for a partial year. An REI with a December 31, 2013 fiscal year end will be required to file a report by May 30, 2014 disclosing payments made from October 1, 2013 to December 31, 2013. Although the new rules may become subject to challenge in court, we recommend that REIs immediately begin planning for the implementation of the new rules given the considerable time necessary to prepare for compliance with the rules.