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The SEC's Payment Disclosure Rule for Resource Extraction Issuers

Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added Section 13(q) to the Securities Exchange Act of 1934 (the "Exchange Act"), requiring the Securities and Exchange Commission ("SEC") to issue rules requiring resource extraction issuers to annually report payments made to a foreign government or the United States federal government for the purpose of the commercial development of oil, natural gas or minerals. The purpose of Section 1504 was to increase the transparency of payments to governmental entities by reporting companies engaged in the development of oil, natural gas or minerals.

On August 22, 2012, the SEC adopted new Exchange Act Rule 13q-1 and amended new Form SD, which had been adopted as part of the SEC's "conflict minerals" rules, to implement the requirements of Section 13(q). Rule 13q-1 requires resource extraction issuers to make annual disclosures on new Form SD of payments made by the issuer, its subsidiaries, and entities under its control to a foreign government or the U.S. federal government for the purpose of the commercial development of oil, natural gas or minerals.

This article outlines the new rule, analyzes the rule's application, and explains the disclosure requirements and compliance dates.

Application of Rule 13q-1

Rule 13q-1 only applies to "resource extraction issuers," which are companies (i) required to file an annual report with the SEC on Form 10-K, Form 20-F or Form 40-F; and (ii) engaged in the commercial development of oil, natural gas, or minerals, regardless of the size of the company or the extent of its business operations constituting commercial development of oil, natural gas, or minerals. The rule does not provide any exemptions or exceptions. Moreover, no exemption exists for situations where foreign law may prohibit the required disclosure, instances when an issuer has a confidentiality provision in a relevant contract, or for commercially sensitive information.

Whether a reporting company is a resource extraction issuer depends on its specific facts and circumstances, particularly whether the company engages in the "commercial development of oil, natural gas, or minerals," which is defined as the activities of exploration, extraction, processing, and export of oil, natural gas, or minerals, or the acquisition of a license for any such activity.

This definition captures only activities directly related to the commercial development of oil, natural gas, or minerals. The rule does not cover ancillary or preparatory activities, the transportation of oil, natural gas, or minerals (other than for export), marketing activities, security support, or the manufacturing of a product used in the commercial development.

The SEC provided some guidance on the particular activities covered by the rule. For example, "extraction" includes the production of oil and natural gas and the extraction of minerals while "processing" includes field processing activities, such as the processing of gas to extract liquid hydrocarbons, the removal of impurities from natural gas after extraction and prior to its transport through the pipeline, the upgrading of bitumen and heavy oil, and the crushing and processing of raw ore prior the smelting phase. Processing, however, does not include refining or smelting. "Export" includes the export of oil, natural gas, or minerals from the host country, but not the removal of the resource from the place of extraction to the refinery, smelter, or first marketable location.

Nevertheless, further SEC guidance on the rule's scope and application is warranted and hopefully forthcoming. SEC guidance or interpretations may provide clarification as to the extent certain issuers, such as oilfield service companies, and certain activities, such as fracturing, are covered by the new rule.

Disclosure Required

A resource extraction issuer must disclose payments made to a foreign government or to the U.S. federal government. A "foreign government" includes a foreign national or subnational government, a department, agency or instrumentality of a foreign government, or a company at least majority-owned by a foreign government. Payments to state and local governments in the United States, however, are not covered by the rule.

A "payment" means an amount paid that is:

(i) made to further the commercial development of oil, natural gas, or minerals; and
(ii) is "not de minimis," which means any payment, whether a single payment or series of payments, that equals or exceeds $100,000 during the most recent fiscal year. In the case of any arrangement providing for periodic payments, a resource extraction issuer must consider the aggregate amount of related periodic payments in determining whether the payment threshold has been met.

Resource extraction issuers must disclose a broad array of "payments," including:

(i) taxes;
(ii) royalties;
(iii) fees (including license, rental, entry, and concession fees);
(iv) production entitlements;

(v) bonuses (including signature, discovery, and production bonuses);
(vi) dividends; and
(vii) payments for infrastructure improvements (but not social or community payments).

The covered issuer must disclose payments for taxes levied on corporate profits, corporate income, and production, but not payments for taxes levied on consumption, such as value added, personal income, or sales taxes. In addition, dividends paid to a government as a common or ordinary shareholder of the issuer would not need to be disclosed as long as the dividend is paid to the government under the same terms as other shareholders. The issuer will be required however to disclose any dividends paid to a government in lieu of production entitlements or royalties.

Moreover, resource extraction issuers must disclose payments of the types identified in the rules that are made in-kind. Accordingly, the covered issuer will need to determine the monetary value of in-kind payments based on cost, or if cost was not determinable, fair market value, and provide a brief description of how the monetary value was calculated.

A resource extraction issuer will be required to not only disclose payments it makes directly, but also payments made by any subsidiary or any entity under its control.[1] The issuer will need to consider all relevant facts and circumstances when determining whether it has control of an entity. An issuer will be deemed to control any entity consolidated in the financial statements included in the issuer's Exchange Act reports. An issuer may also be required to provide disclosure for entities in which it provides proportionately consolidated financial information.

A resource extraction issuer may not circumvent the rule by re-characterizing payments or activities that otherwise would fall within the scope of the rule. Accordingly, the SEC added an anti-evasion provision, requiring disclosure with respect to an activity or payment that is part of a plan or scheme to evade the required disclosure.

Method and Form of Disclosure

The covered issuer must annually disclose the required payment information on new Form SD, which must be filed on EDGAR, the SEC's public database, no later than 150 days after the end of the issuer's fiscal year. The issuer must include a brief statement in the body of the form directing users to the detailed payment information provided in an exhibit. The required exhibit must provide the information using the eXtensible Business Reporting Language ("XBRL") interactive data standard with electronic tags that identify:

(i) the type and total amount of payments made for each project;

1 "Control" and "subsidiary" have the meanings set forth in Rule 12b-2 of the Exchange Act. "[C]ontrol means "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." A "subsidiary" is defined as "an affiliate controlled by such person directly, or indirectly through one or more intermediaries.

(ii) the type and total amount of payments to each government;
(iii) the total amount of payments, by category;
(iv) the currency used to make the payments;
(v) the financial period in which the payments were made;
(vi) the business segment[2] of the resource extraction issuer that made the payments;
(vii) the government that received the payments, and the country in which the government is located; and
(viii) the project of the resource extraction issuer to which the payments relate.

To the extent that payments are made for obligations at the entity level, issuers may omit certain tags that may be inapplicable for those payment types as long as they provide all other electronic tags. The SEC does not require the payment information to be audited or provided on an accrual basis. Payments must be disclosed in either U.S. dollars or the issuer's reporting currency. An issuer may choose to calculate the currency conversion in one of three prescribed ways, but must disclose the method used.

Although disclosure must generally be made at the project level, the SEC left "project" undefined to give issuers flexibility in applying the term to different business contexts, but the SEC did provide some guidance. The SEC noted that the contract between the government and the issuer will generally provide a basis for determining the payments, and required payment disclosure, that would be associated with a particular "project." The SEC declined to define "project" based on a materiality standard, or as a reporting unit for financial reporting purposes. In addition, the SEC stated that it is seeking more granular disclosure than country-level reporting. Nonetheless, an issuer is permitted to disclose payments at the entity level if the payment is made for obligations levied on the issuer at the entity, rather than project, level. Thus, if the issuer has more than one project in a host country, and that country's government levies corporate income taxes on the issuer with respect to the issuer's income in the country as a whole, and not with respect to a particular project within the country, the issuer would be permitted to disclose the resulting income tax payment(s) without specifying a particular project associated with the payment.

Liability for Payment Disclosures

The payment information on Form SD will be *filed* rather than *furnished*, thus potentially subjecting the resource extraction issuer to liability under Section 18 of the Exchange Act, in addition to the general antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5. The information in Form SD, however, will not be deemed incorporated by reference into Securities Act or Exchange Act filings, unless the issuer affirmatively incorporates the report into such filing. In addition, the disclosures are not subject to the officer certifications required under Rules 13a-14 and 15d-14 of the Exchange Act.

2 "Business segment" means a business segment consistent with the reportable segments used by the resource extraction issuer for financial reporting purposes.

Transition and Compliance Dates

Rule 13q-1 became effective November 13, 2012, and resource extraction issuers must begin complying with the new rule and Form SD for fiscal years ending after September 30, 2013. For the first report filed for fiscal years ending after September 30, 2013, the issuer may provide a partial year report if the issuer's fiscal year began before September 30, 2013. The issuer will be required to provide a report for the period beginning October 1, 2013 through the end of its fiscal year. For any fiscal year beginning on or after September 30, 2013, an issuer will be required to file a report covering the full fiscal year.

Legal Challenge

On October 10, 2012, the U.S. Chamber of Commerce and three other industry groups filed a petition for review and complaint in federal courts in Washington, D.C., seeking to overturn Rule 13q-1. On November 8, 2012, the SEC denied a request to stay the implementation of Rule 13q-1 and Form SD pending the outcome of the lawsuit. Oral argument before the D.C. Circuit Court of Appeals is scheduled for March 22, 2013.