

New SEC Rules For Resource Extraction Issuers to Disclose Payments to Governments

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Client Advisory

September 28, 2012 by Steven J. Glusband, Guy P. Lander, Bruce A. Rich and Gideon Even-Or

The SEC recently adopted rules requiring resource extraction issuers to disclose the type and the amount of certain payments to governments relating to their commercial development of oil, natural gas or minerals. All issuers engaged in oil, gas or mineral development activities that are subject to filing annual reports with the SEC under the Securities Exchange Act of 1934 (the "Exchange Act"), including foreign private issuers with their resource extraction activities outside of the U.S., are subject to these rules.^[1]

Affected issuers must comply with these rules beginning with their first fiscal year ending after September 30, 2013 by filing a Form SD within 150 days after the end of that fiscal year. While companies now have plenty of time before filing their first Form SD, which would be May 2014 at the earliest; nevertheless, they and their subsidiaries and controlled entities should now become aware of possible future disclosures when negotiating contracts with governments or otherwise committing to cash and non-cash payment arrangements that might be covered by these rules.

These rules, together with companion rules for disclosures also on Form SD by issuers that use "conflicts minerals" in their products, were adopted by the SEC to implement Sections 13(p) and 13(q) of the Exchange Act, which are part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The concept for these rules stems from the commitment of the U.S. government to international efforts to promote transparency in the commercial development of oil, natural gas and minerals, rather than enhancing any financial markets reform. The rules intend to be consistent with what are deemed payments under the Extractive Industries Transparency Initiative ("EITI"). However, currently, neither the U.S. nor Canada is an EITI implementing country.

General Rule Covering Payments to Governments

The general rule is that a "resource extraction issuer" must disclose "payments" made by it, its subsidiaries or its controlled entities to a "foreign government or the U.S. government" for each "project" undertaken for the purpose of commercial development of oil, natural gas or minerals. The disclosure would be on the new Form SD. No exemptions from filing are available even if a foreign law prohibits the disclosure or if the issuer is subject to a confidentiality agreement. This Form is to be filed as a standalone document, and not part of the issuer's annual report on Form 10-K, 20-F or 40-F.

The following analyzes the terms comprising the general rule that would trigger its application.

Resource Extraction Issuer "Resource Extraction Issuer" is any U.S. or foreign issuer (i) required to file an annual report with the SEC and (ii) engaged in the commercial development of oil, natural gas or minerals, regardless of the issuer's size or the extent of its business operations in developing oil, natural gas or minerals. Although the SEC acknowledged in its adopting release that filing a Form SD could cause foreign private

issuers to face competitive disadvantages and risk concerns in their home countries, it concluded that the transparency objectives of Dodd-Frank required these disclosures by all SEC reporting companies.

Payments Payment means amounts paid by the issuer, its subsidiaries or its controlled entities that:

- further their commercial development of oil, natural gas or minerals,
- constitute taxes (such as taxes on corporate profits, corporate income or production, but excluding sales tax, VAT and other taxes levied on consumption), royalties, fees (including license fees), production entitlements, bonuses (including signature, discovery and production bonuses), dividends (other than those paid pro rata to all shareholders) and infrastructure improvements, and
- are “not de minimis” in amount.

Within each of these categories of expense in clause (ii) above is an overall concept of “other material benefits,” which is intended to include payments that are part of any “commonly recognized revenue stream” for such commercial development.

“Not de minimis” means any payment, whether a single payment or a series of related payments, that equal or exceed U.S.\$100,000 during the fiscal year. An instruction to Form SD mentions that in determining whether arrangements for periodic payments or installments come within the “not de minimis” exception, the issuer must consider the aggregate amount of the related payments or installments.

“Infrastructure improvements” is explained by the SEC as possibly the cost of building a road or railway, whether by contract or voluntarily, needed for the development of the area where the minerals are located. For example, if an issuer is obligated to build a road rather than paying the host country government to build the road, the issuer would be required to disclose the cost of building the road as a payment to a government if the payment is not de minimis. However, the issuer need not disclose social or community payments, such as payments to build a hospital or a school, as the SEC stated it was not clear that these payments are part of the commonly recognized revenue stream. The SEC release does not provide specific guidance whether payments such as to First Nations groups under Canadian law would be considered “social or community payments.” We are seeking clarification from the SEC Staff about those types of payments.

Foreign government or U.S. government “Foreign government” means a foreign national or a foreign subnational government. A “foreign national government” includes the departments, agencies, instrumentalities under and companies majority-owned by a foreign government. A “foreign subnational government” means governments of a state, province, county, district, municipality or territory under a foreign government.

In contrast, the U.S. government is just the federal government of the United States, and its agencies, excluding state or local governments or their subnational governments. For example, payments by a resource extraction issuer to the U.S. Bureau of Land Management would be payments to the U.S. government that could be subject to being disclosed on Form SD, while payments to the State of Nevada or a local county or agency in Nevada would not be payments to the U.S. government for purposes of disclosure on Form SD.

Project Although issuers must disclose the type and amount of payments for each project, the SEC expressly omitted a definition for “project” because of the difficulty in choosing a single industry acceptable definition. It felt that by leaving “project” undefined an issuer should have some flexibility in applying the term to its different business contexts depending on factors in the industry in which the issuer operates or the issuer’s size. The SEC expressed that what is or is not a project for purposes of Form SD could be based upon the same concepts an issuer uses to disclose “projects” in its other Exchange Act reports and public statements

Commercial development of oil, natural gas or minerals includes exploration, extraction, processing, export and other significant actions relating to those activities or the acquisition of a license for any of those activities. While the SEC definition of commercial development is broader than

that of the EITI, the SEC release acknowledges that ancillary or preparatory activities, such as refining, smelting, transportation and marketing, are outside of the definition.

Reporting on Form SD

Form SD is filed with the SEC through EDGAR and electronically formatted using the XBRL interactive data standard. The filing due date is no later than 150 days after the end of the issuer's fiscal year. The first filing is for fiscal years ending after September 30, 2013 and with disclosures from that date. Therefore, the first Form SD of a calendar year company would be due on May 30, 2014 and cover the period from October 1, 2013 through December 31, 2013. Thereafter, Form SD would cover the company's entire fiscal year.

Form SD requires the data to be shown by electronic tag that identifies the following payment information:

- the total amounts of payments, by category;
- the currency used to make the payments;
- the financial period in which the payments were made;
- the business segment of the issuer that made the payments;
- the government that received the payments, and the country in which the government is located; and
- the project of the issuer to which the payments relate.

The payment information in the Form SD need not be audited or provided on an accrual basis. The amounts can be presented in U.S. dollars or the issuer's reporting currency. When the payment made to a government is in currencies other than that of the U.S. or the issuer's reporting currency, the company may convert the payment into U.S. or its reporting currency by one of the following methods: (i) by translating the amount at the exchange rate existing at the time the payment is made, (ii) using a weighted average of the exchange rates during the reporting period or (iii) basing it on the exchange rate as of the company's fiscal year end. The method chosen for the currency conversion must be disclosed.

The SEC anticipates that appropriate XBRL taxonomy will be available before the first filing date. Foreign private issuers that prepare their financial statements under International Financial Reporting Standards do not have experience with XBRL. They will incur some start-up costs associated with XBRL in preparing the Form SD. The SEC speculated that these costs would not be much greater than if these companies filed the data in XML.

Some additional points about the Form SD:

- issuers will not be able to obtain confidential treatment for any specific information presented in the Form,
- the Sarbanes-Oxley officers' certification rules covering Forms 10-K, 20-F and 40-F and other SEC filings do not apply,
- for information in their Form SD, issuers will be subject to the same liability that applies to them for their other reports deemed filed under the Exchange Act and
- information in and documents filed with this Form will not be automatically incorporated by reference into an issuer's filings under the Securities Act of 1933 or the Exchange Act unless the issuer expressly incorporates them by reference in its registration statements or other reports.

As previously noted, reporting companies have substantial time until the spring of 2014 to prepare and file their the initial Form SD. However, we suggest that these companies establish collection and monitoring procedures for themselves now, and especially their foreign divisions and subsidiaries and controlled entities, for payments or payment arrangements that could be deemed to be made to a government in connection with their oil, natural gas or minerals activities that could require disclosure in a Form SD.

Over the next few months, the SEC staff should be releasing interpretative guidance concerning disclosures and procedures by resource extraction issuers for preparing and filing their Form SD. We intend to publish periodic client advisories covering future SEC guidance or amendments to these payment disclosure rules.

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Endnote

[1] Exchange Act Release No. 34-67717, Aug. 22, 2012.

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