Extraction and compliance: new reporting requirements for issuers involving oil, natural gas or minerals

Nov 03 2010 Rebekah J Poston and Carine M Williams

As people who work in extraction-related industries can attest, you never know what you'll find on a deep dig. So it is with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) a tome of overhaul legislation enacted to improve risk regulation in the financial services sector. Tucked in on the 845th page of the 848 page Act, under the title of "Miscellaneous Provisions," are some notable, surprise specifications which will significantly impact the natural resource extraction industry. Section 1504 of the Act requires publicly traded companies to disclose annually to the Securities and Exchange Commission (SEC) all payments made to governments — US or foreign — in connection with projects that relate to the commercial development of oil, natural gas or minerals.

The Act was signed into law on July 21, 2010. Under the Act, the SEC must adopt new final rules directing the implementation of these reporting requirements by April 15, 2011. Understanding how section 1504 will impact extraction industries — and the member firms connected to them — requires sifting the plain mandates of the Act from outstanding ambiguities that will likely remain unclear until these final rules are adopted. The SEC will have to hone sharper-lined guidance for companies to discern who precisely will need to report payments to governments, and for what sorts of activities, and for companies to assess accurately the degree of added compliance costs that will be generated by the Act.

Payments to governments

Section 1504 amends section 13 of the Securities Exchange Act of 1934, which currently sets forth various reporting rules for securities issuers. The new reporting requirements of section 1504 specifically apply to "resource extraction issuers," who must now disclose to the SEC those payments made to governmental entities on an annual basis.

Section 1504 defines a resource extraction issuer as, "an issuer that: (i) is required to file an annual report with the Commission; and (ii) engages in the commercial development of oil, natural gas, or minerals." The "commercial development of oil, natural gas, or minerals" is broadly defined as including, "exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the Commission."

This language makes it unclear whether the Dodd-Frank Act applies to companies engaged in upstream resource extraction activities, as "commercial development" suggests, or if section 1504 also contemplates midstream and downstream activities, as "processing," and "other significant actions" respectively suggest. So, while a public company with aluminum mining plant facilities would plainly be required to follow the reporting rules of section 1504, it is uncertain whether section 1504 would apply to a public company which purchases aluminum to manufacture and export aluminum widgets.

The Act is somewhat clearer with respect to identifying the recipient of payments contemplated by the Act. Governmental entities include the US government, as well as foreign governments. Thus reporting presumably would include, for example, disclosure of payments made on mining claims, mining leases and mineral materials sales to the US Bureau of Land Management. "Foreign government" as set forth by section 1504, includes governing bodies as well as "a department, agency, or instrumentality of a foreign government," and "a company owned by a foreign government." Determining when a company is an "instrumentality of" or "owned by" a foreign government for purposes of enforcing section 1504 could present interesting quandaries, especially in light of how expansively the SEC and the Department of Justice have interpreted government instrumentalities and state owned enterprises in the Foreign Corrupt Practice Act (FCPA) context. Under the FCPA, a company can be considered an instrumentality of a foreign government if a foreign government owns a majority of shares or controls the business.

Section 1504 reporting must disclose the type and total amount of payments made to any government entity for each project that relates to the commercial development of oil, natural gas or minerals, as well as the type and total amount of such payment to each government.

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Payments defined

Under the Act, "payment" is defined as a payment that furthers the commercial development of oil, natural gas, or minerals and is not *de minimis*. Section 1504 specifies that such payments include taxes, royalties, fees (including license fees), production entitlements, bonuses and other material benefits that the SEC determines are part of the commonly recognized revenue stream for the commercial development of oil, natural gas, or minerals. One such benefit could include purchase obligations — enforceable agreements to purchase volumes or quantities from an extraction project — that were negotiated in contemplation of the commercial development of that extraction project.

Definitions for oil, natural gas, and minerals

Section 1504 does not provide definitions for oil, natural gas or minerals. Although activities like geothermal energy extraction and the extraction of minerals from sea are facially resource-extraction activities, the International Accounting Standards Board (IASB) — an independent, private-sector organization that develops and approves International Financial Reporting Standards — has suggested that they should not be considered extractive because geothermal energy is not non-regenerative, and because sea-mineral extraction implicates risks very different from the risks associated with land-based mineral extraction. Comments submitted to the SEC in September, 2010, request that the SEC adopt the IASB's definitions of oil, natural gas and minerals in the final rulemaking process.

Finally, the Act directs the SEC to make available to the public, online, "to the extent practicable," a compilation of the information reported by resource-extraction issuers. It does not make clear how the publicly available information will be aggregated, if at all; how timely the publicly available compilation must be; or how confidentiality concerns regarding competitively sensitive information will be addressed.

Extractive industries transparency initiative

Section 1504 expressly mandates that the SEC consider the guidelines of the Extractive Industries Transparency Initiative (EITI) in determining which payments are part of the commonly recognized revenue stream for resource extractions. The Act further provides that, to the extent practicable, in developing the final rules for implementing section 1504 of the Act, the SEC "shall support the commitment of the Federal Government to international transparency promotion efforts relating to the commercial development of oil, natural gas, or minerals," and that the SEC may consult with any agency or entity it deems relevant in the final rulemaking process.

Launched in 2002, at the World Summit on Sustainable Development, the EITI's stated objective is to promote revenue transparency in natural resource management by establishing a "methodology for monitoring and reconciling company payments and government revenues at the country level." This methodology asks companies in the extractive industry to "publish what they pay," or voluntarily disclose outlays to government entities. The EITI also asks national governments to implement a standardized, multi-step process requiring preparation, disclosure, dissemination, monitoring and evaluation, and then to submit to independent validation assessment. EITI's website reports that 31 countries are EITI compliant, or on the way to becoming EITI compliant, and that a number of other countries — including the United States — provide financial support and political leadership in promoting the EITI. The EITI also reports that 50 of the world's largest oil, gas and mining companies already participate in the EITI process.

Gauging extra compliance costs

Until the SEC has published its final rules, it is difficult to assess how much added compliance costs will be generated as a result of the Act. However, at this stage, it is clear that public companies in extraction-related industries — even those companies that already voluntarily participate in the EITI — will need to gear up to satisfy the Act's reporting requirements.

Compliance with section 1504 will surely entail significant technological system modifications. The Act requires that the annual report be submitted using an interactive data standard. Data in the report must include electronic tags that identify: 1) the total amounts of the payments, by category; 2) the currency used to make the payments; 3) the financial period in which the payments were made; 4) the business segment that made the payments; 5) the government that received the payments and the country in which the government is located; and 6) the project to which the payments relate. Other electronic tags may be required, as determined by the SEC.

Companies will have to disclose the required information on payments made for the first full fiscal year after the final rules are issued. To prepare for this eventuality, companies should assess their existing processes for tracking and verifying the payments they make to governments on a project-by-project basis. Companies that already participate in the EITI may find they already have in place at least some of the data-capture vehicles needed to deliver required information under the Act. As needed, companies will have to develop new procedures to capture all the information that must be reported under the Act, and prepare technologically to disclose that information pursuant to the Act's interactive data standard.

Because the reported data will be available to the public online, companies need to prepare for potential shareholder and media response. Depending on the nature of the information made available online — the SEC could publish reported payments on a project-by-project basis — companies may have to plan for the contingency that competitively sensitive information will be made public. In the event that the SEC does publish such detailed information online, companies may also need to evaluate contractual

reporting requirements will not fall on unlisted competitor companies should be considered in the business development plans and objectives of resource extraction issuers.

SEC, by submitting formal comments and by engaging the final rulemaking process. At this juncture, the SEC has heard from the EITI, the American Petroleum Institute, representatives of the Information Technology Industry Council, the National Association of Manufacturers and the Publish What You Pay Coalition, among many others.

Conclusion

and observed: "We know that countries are more likely to prosper when governments are accountable to their people. So we are leading a global effort to combat corruption — which in many places is the single greatest barrier to prosperity, and which is a

profound violation of human rights. That's why we now require oil, gas and mining companies that raise capital in the United States to disclose all payments they make to foreign governments."

Section 1504 may impose new and significant compliance burdens on extraction issuers. However, if the SEC adopts clear, comprehensive final rules to mitigate these burdens, and the extractive industry proactively prepares to meet the new reporting requirements, the benefits that flow from heightened transparency can be shared by all stakeholders. Section 1504 could indeed ultimately prove to be a diamond in the rough.

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