SUPPORT THE CONGRESSIONAL REVIEW ACT DISAPPROVAL RESOLUTION FOR THE DODD-FRANK SECTION 1504 RULE

Frequently Asked Questions

What is Section 1504?

Section 1504 of the Dodd-Frank law directs the Securities and Exchange Commission (SEC) to adopt a rule compelling resource-extraction issuers to report payments made to the U.S. and foreign governments for the commercial development of oil, gas, and minerals,[1] and then, "[t]o the extent practicable," "make available online, to the public, a compilation of th[at] information."[2]

Why was the original Section 1504 rule vacated?

The SEC's original Section 1504 rule, finalized in August 2012, was vacated by the U.S. District Court for the District of Columbia in July 2013, in response to an API lawsuit, due to "two substantial errors."[3] Specifically, the SEC had "misread [Section 1504] to mandate public disclosure of the reports," and had arbitrarily and capriciously declined to provide an exemption for countries that prohibit disclosure.[4] The court admonished the SEC for "abdicat[ing] its statutory responsibility to investors" by pursuing an overly broad view of Section 1504's purpose "no matter the cost" to issuers.[5]

Does the oil and natural gas industry support transparency?

- Yes, many of oil and natural gas companies are longstanding supporters of transparency initiatives such as the Extractive Industries Transparency Initiative (EITI).
    - EITI is a multi-lateral, multi-stakeholder global initiative composed of energy companies, civil society organizations, and host governments.
    - Once implemented, the EITI rules apply equally to all companies operating in a country, including NOCs, ensuring a level playing field for all companies.
    - EITI provides mechanisms for independent verification and reconciliation of the companies' payments with the host government's receipts. The Section 1504 rule does not.
    - Currently, there are 51 implementing countries of EITI, including the United States.

- API itself has been heavily involved in the implementation of U.S. EITI through our membership on the U.S. EITI's multi-stakeholder group.

[1] Exchange Act § 13(q)(2)(A), 15 U.S.C. § 78m(q)(2)(A).
[2] Id. at § 78m(q)(3).
[3] API v. SEC, 953 F. Supp. 2d 5, 11 (D.D.C. 2013).
[4] Id.
[5] Id. at 23.

- The SEC could have promoted transparency via Section 1504, while remaining true to its core mission to protect investors, competition, and the efficiency of capital markets, but failed by ignoring the suggestions of issuers.

Is repeal of Section 1504 a vote in favor of corruption?

- Section 1504 is not about reporting corruption, as it would capture regular payments to a government entity. Instead, the U.S. Foreign Corrupt Practices Act (FCPA) has prohibited illicit payments by companies to foreign officials since 1977 and companies must adhere to this law enforced by the Department of Justice.

- No, this a vote for Congress to reset the regulatory process when agencies fail to develop balanced rules. By passing the resolution to disapprove the Section 1504 rule, Congress can reclaim its authority, and in the process, protect American companies, workers, and investors.

- At the same time, API and our member companies support transparency. Many of our member companies operate and make significant investments in developing business and community partnerships in countries around the world.

- It is in the best of interests of the local community, Americans working abroad, the local residents the companies employ, and investors to have governments that are as transparent and accountable as possible.

- In fact, API and many of our member companies are longstanding supporters of global transparency initiatives such as the Extractive Industries Transparency Initiative (EITI), a multi-lateral, multi-stakeholder global initiative composed of energy companies, civil society organizations, and host governments. Once implemented, the EITI rules apply equally to all companies operating in a country, including NOCs, ensuring a level playing field for all companies.

What is the estimated compliance cost of Section 1504?

- The SEC estimates that the new rule will:
  - **Impose total initial compliance costs between $239 million and $700 million** and **annual ongoing total compliance costs between $96 million and $591 million**; and
  - **Require a total of over 217,000 hours** to comply with the rule over a three year period.

- Companies would be required to spend this despite the SEC acknowledgement in the final rule that “the direct incremental benefit to investors of this information may be limited.”

What are other solutions for promoting transparency and global competitiveness?

- The SEC could have made important changes to the final rule that would have substantially reduced the rule’s costs while more effectively promoting Section 1504’s statutory purposes. Specifically:

  - Adopt API’s proposed model for issuer filings which will reduce the risks and harms associated with forcing companies to disclose sensitive, contract-level information that can be exploited by competitors

while serving the law's transparency objectives by making the disclosed information more accessible to and usable by the public.

  - Make available, online, a compilation of payment information, instead of requiring issuers to disclose publicly payments made to the U.S. and foreign governmental entities.

  - Exempt disclosures that would violate a host country's laws and existing contracts, reveal commercially sensitive information, or jeopardize the safety of an issuer's personnel.

- Unfortunately, the SEC, during the rule-making process for the original 2012 rule, ignored the suggestions of issuers to shape a rule that achieved Section 1504's intended purpose without overburdening U.S.-publicly listed energy producers with a new, costly regulation that placed them at a competitive disadvantage to state-owned competitors around the world and that could endanger the safety of American employees working abroad.

- The U.S. District Court for the District of Columbia, in response to an API lawsuit, agreed with our position and vacated the rule.

- In 2016, the SEC issued a substantially similar rule to the 2012 version, and ignored our suggestions again.

- The SEC could have made important changes to the final rule that would have substantially reduced the rule's costs while more effectively promoting Section 1504's statutory purposes.

What are the major issues with the new Section 1504 rule?

Despite the district court ruling, the SEC finalized a new Section 1504 rule in June 2016, which is substantially similar to the original August 2012 rule and fails to strike the right balance between informing foreign citizens of government revenues and protecting the competitiveness of American companies.

Mandating Company-Specific Public Disclosure vs. Compilation of Information

- As the district court held in vacating the SEC's original rule, Section 1504 does not mandate company-specific, public disclosure.[6] Despite that determination, the SEC again opts to require issuers to disclose publicly payments made to the U.S. and foreign governmental entities.

- The district court's opinion and the plain language of the statute confirm that the SEC should have required companies to disclose payment information to the SEC confidentially and that the SEC "shall" then make a "compilation of" that information available to the public "to the extent practicable."[7]
- This two-step process is consistent with the intent of disclosing information about the amount of money received by the U.S. and foreign governments from resource-extraction issuers.

[6] API v. SEC, 953 F. Supp. 2d at 12-20.
[7] Section 13(q)(3)—titled "Public availability of information"—requires the Commission, "[t]o the extent practicable," to "make available online, to the public, a compilation of the information required to be submitted" by issuers "under the rules issued under [Section 13(q)](2)(A)." 15 U.S.C. § 78m(q)(3)(A); see also API v. SEC, 953 F. Supp. 2d at 18-19.

- Confidential, company-specific disclosures followed by a public “compilation” would not only satisfy the plain language of Section 1504 but would substantially reduce the burdens imposed by the SEC’s final rule.

- By permitting confidential, company specific disclosures and then aggregating that information in a public “compilation,” the SEC would have fulfilled its obligation to “make available online, to the public, a compilation,” while also ensuring that companies are not required to make commercially sensitive information publicly available.[8]

- Moreover, because Section 1504 requires the SEC to make information publicly available only “[t]o the extent practicable,” the SEC has the ability to produce a compilation”—defined as “something that is a product of the putting together of two or more items”[9]—that minimizes the competitive harm to issuers by omitting the most sensitive data.

Public Disclosure Imposes Competitive Harm on Issuers and Risks the Safety of Their Employees

- Compelled public disclosure forces issuers to reveal highly confidential, commercially sensitive information. That puts American issuers at a competitive disadvantage relative to competitors, many of whom are not subject to similar disclosure requirements either because they are unlisted or because they are based in countries that do not require public disclosure.

- Compelled public disclosure is also harmful because it may endanger the safety of an issuer’s employees. If an issuer is forced to disclose publicly its payments to a government (including specific and granular information about the precise geographic location of its operations), insurgents or terrorist groups can use that information to learn where the government is most vulnerable, and then target the issuer’s facilities and personnel.

The Proposed Definition of “Project” Imposes Competitive Burdens on Issuers because it Forces Them to Reveal Commercially Sensitive Information

- The harm that results from compelled public disclosure is exacerbated by the SEC’s decision to define “project” at an unnecessarily granular level.

- Section 1504 requires issuers to disclose “the project of the resource extraction issuer to which the payments relate.”[10] Importantly, Congress defined several terms in Section 1504 but left “project” undefined, confirming Congress’s intent that the SEC adopt a definition that promotes transparency, while also ensuring that any burden on competition is necessary and appropriate and minimizing the harm to issuers, their shareholders, and capital markets.[11]

- Instead, the Section 1504 rule defines a resource-extraction “project” as “operational activities that are governed by a single contract, license, lease, concession, or similar legal agreement, which form the basis for

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[8] 15 U.S.C. § 78m(q)(3)(A); see also Bus. Roundtable v. SEC, 647 F.3d 1144, 1151-53 (D.C. Cir. 2011) (the Commission must consider whether lower-cost alternatives will be equally effective).
[9] Webster’s Third Int’l Dictionary 464 (1976); see also Black’s Law Dictionary 344 (10th ed. 2014) (defining “compilation” as a collection of materials “arranged in an original way,” such that “the resulting product constitutes an original work of authorship”).
[10] 15 U.S.C. § 78m(q)(2)(D)(ii)(VI).
[11] See Exchange Act §§ 3(f), 23(a)(2), 15 U.S.C. §§ 78c(f), 78w(a)(2).

payment liabilities with a government." In addition, the proposed rule requires issuers to identify the "specific, subnational, geographic location" of each project.

- The definition of "project" in the proposed rule puts issuers at a critical disadvantage with respect to competitors that are not subject to the rule or similar requirements—for example, many state-owned oil companies—because it forces issuers to reveal commercially sensitive information to the public.

- First, other resource-extraction companies can use contract-specific disclosures to harm the disclosing issuer.
    - For example, if a competitor knows what an oil company paid for drilling rights under a specific contract, the competitor can learn the value the issuer places on a particular asset—e.g., a block of acreage in territory that the government has recently made available for development. Competing oil companies often have very different views of a region's development potential because of differences in technology, scientific expertise, or experience. Thus, an issuer's valuation of new territory is a closely guarded secret, lest competitors piggyback on the issuers' hard-earned knowledge.

- Second, host governments themselves can use public, contract-specific information about an issuer's payments to other governments to the issuer's disadvantage.
    - For example, if one government knows the size of a bonus an SEC filer paid under an earlier contract in a different country, the government will expect at least the same amount in a new agreement with the filer. Likewise, if a government knows the rate of return an SEC filer was willing to accept on an earlier contract, the government can use that information in its negotiations with the filer to gain more favorable terms, to the filer's detriment and the detriment of its shareholders.

- Third, because contract-specific information is also viewed as sensitive by host governments, those governments may be less willing to enter into agreements with issuers that are subject to the proposed rule, and may instead choose to do business with competitors—like state-owned oil companies—that are not obligated to disclose information that the governments would rather keep confidential.

<u>The Final Rule Improperly Omits Exemptions for Countries that Prohibit Disclosure and for Contracts that Prohibit Disclosure without the Contracting Government's Permission</u>

- Despite the district court's decision in 2013, the SEC's final rule once again lacks an exemption for circumstances in which disclosure under Section 1504 would violate a host country's laws.

- The district court vacated the SEC's first rule, in part, because it failed to provide any reasoned explanation for its refusal to provide exemptions for companies in countries that prohibit the disclosure of payments to the government, deeming that omission a "serious error that independently invalidate[d] the Rule."[12]

- The SEC's failure to grant an exemption imposes an enormous burden on issuers who have billions of dollars in assets in countries in which public disclosure under Section 1504 would be illegal.
    - As an initial matter, API can confirm that at least two countries—Qatar and China—continue to prohibit the required disclosures.[13]

[12] *API v. SEC*, 953 F. Supp. 2d at 20.

- Although issuers may be able to seek permission from a host government to disclose payment information on a case-by-case basis, the government would be under no obligation to grant that permission.

- Issuers' employees could find themselves subject to criminal prosecution for facilitating the release of such information. Moreover, aside from the enormous costs associated with forced violation of a host country's law or contracts, the SEC's failure to grant an exemption imposes severe competitive harm on U.S. listed companies whose competitors, including many state-owned oil companies, will not be subject to the SEC's rule.

If other countries, including those in the European Union, are requiring resource extraction issuers to disclose payments to foreign governments, what is wrong with the Section 1504 rule?

- There are two key provisions of the Section 1504 rule that differ from the EU requirements that add compliance burdens and create a competitive disadvantage for U.S. reporting companies.

First Provision of the Section 1504 rule that differs from EU requirements

- Specifically, Section 1504's requirement to report a company's proportional share of government payments for projects even if the company is not the "operator" and did not actually make the government payment and the requirement to value in-kind entitlement barrels at cost.

- By way of further explanation, companies often engage in joint ventures to develop oil and natural gas resources. One party to the joint venture is typically the "operator"— meaning the company has operational responsibility for the project—while one or more other companies are "non-operators"—meaning the companies have a financial investment in the project but do not take part in the actual operation of the project.
    - The costs of developing the project are typically allocated on the basis of ownership in the joint venture.
    - For example, Company X might be the operator with a 40 percent financial interest in the project, Company Y might be a non-operator with a 30 percent financial interest, and Company Z might also be a non-operator with a 30 percent financial interest.
    - As the operator, Company X would make all payments to the host government for the project.
    - Company X would then subsequently invoice Company Y and Company Z for their shares of the government payment.
    - Neither Company Y nor Z would know the timing of such payments, however.
    - In fact, Company X might invoice Company Y and Z for anticipated payments to the host government even before Company X makes such a payment (known in the business as a "cash call").

[13] *See* Letter from Royal Dutch Shell PLC at Appendix C (May 17, 2011); Letter from Exxon Mobil Corp. at Attachment II (March 15, 2011); *see also In re BDO China Dahua CPA Co., Ltd.*, Initial Decision Release No. 553, at 104-05 (File Nos. 3-14872, 2-15116) (Jan. 22, 2014) (impliedly construing Chinese law to prohibit disclosures of the kind required by the proposed rule).

    - Company Y and Company Z, as non-operators, might not even know the identity of the government or entity receiving payments from Company X, or even the currency of the payment itself.

- Operator invoices do not provide this level of granular detail, and joint venture contracts do not require that operators provide payee specific information to non-operators requiring the disclosures.

- This will lead to incomplete data in the reporting of non-operator amounts by the non-operators who are SEC registrants, as this information will not be available from operators who do not voluntarily choose to provide the information to the non-operators.

- Some of the operators are not SEC registrants and therefore will not be subject to SEC rules

Second Provision of the Section 1504 rule that differs from EU requirements

- Both of these SEC provisions differ from the EU, Canadian, and EITI standards, under which the party making government payments (typically the operator) reports 100 percent of the amount paid, and in-kind barrels are valued at fair market value.

- The different approach under Section 1504 to these items also means that many payment figures in U.S. reports will be "apples and oranges" vs. similar figures in reports filed under other transparency regimes.

- Thus, a user adding up figures from U.S. reports with similar figures in EU or other reports will often NOT get an accurate aggregate total for government receipts since the numbers are being reported on different bases.

- The SEC approach in these areas seems to undermine the fundamental purpose of transparency reporting.

What is the implementation date of the new Section 1504 rule?

- According to the final rule, "the initial Form SD filing for resource extraction issuers would cover the first fiscal year ending on or after September 30, 2018 and would not be due until 150 days later."