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ADVISORY | European Union

June 19, 2013

EU AGREES ON DISCLOSURE RULES FOR EXTRACTIVE AND LOGGING INDUSTRIES

Last week, the European Parliament approved mandatory disclosure requirements for payments to governments by companies in the energy, mining, and logging sectors. The new EU rules will come into force later this year following their expected approval by the Council of Europe. The rules apply to all listed and large unlisted companies registered in the EU without exemption and require the annual reporting of payments made on a country - and project - basis. The disclosure requirements are incorporated in amendments to the Accounting Directives (78/660/EEC and 83/349/EEC), the final text of which was published in late April, and duplicated in the final amendments to the Transparency Directive (2004/109/EC) which were published last month.[1]

The Directives include a number of significant changes from the initial legislative proposals adopted by the European Commission in 2012, as described in our prior client alert on this subject.[2] Member States have until 2015 to transpose the Directives. However, affected companies may wish to utilise the intervening time to prepare for the new obligations - many of which would not be captured in normal corporate reporting routines - and to keep apace of further refinements to the rules by the Commission and individual Member States.

The new disclosure rules are complex, and companies should review them carefully. This memorandum provides an overview of the principal features of the rules.

LEGISLATIVE BACKGROUND

On October 25, 2011, the European Commission proposed mandatory disclosure rules based on guidelines developed by the Extractive Industry Transparency Initiative ("EITI") and modeled on similar disclosure obligations adopted by the U.S. Dodd-Frank Act (as implemented by the Securities and Exchange Commission ("SEC") in August 2012 through Rule 13q-1).[3] Nonetheless, in a joint statement accompanying the Commission's proposals, Internal Market Commissioner Michel Barnier and Development Commissioner Andris Piebalgs emphasised that the Commission intended to "[go] well beyond the U.S. Dodd-Frank Act" in order to establish itself as an "avant-garde in promoting transparency."

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[1] 8328/13 (April 12, 2013) ("the Accounting Directive"); 9841/13 (May 23, 2013) ("the Transparency Directive").

[2] *See EU Proposes Mandatory Disclosure Rules for Extractive Industries*, Covington Advisory (November 3, 2011) (http://www.cov.com/files/Publication/531aa074-f21f-4467-95c1-7d2946b9221f/Presentation/PublicationAttachment/1fb2a621-85eb-47a4-8602-8276fa20f330/EU%20Proposes%20Mandatory%20Disclosure%20Rules%20for%20Extractive%20Industries.pdf).

[3] *See SEC Adopts Resource Extraction Payment Rules*, Covington Advisory (August 29, 2012) (http://www.cov.com/files/Publication/691dca60-ba5d-495c-9120-928c5c527014/Presentation/PublicationAttachment/a1737601-2f7d-40f9-950a-9f06743f174e/SEC_Adopts_Resource_Extraction_Payment_Rules.pdf).

The Accounting Directive and Transparency Directive accomplish that objective by establishing rules that are equivalent to - and in certain instances exceed - the disclosure requirements of SEC Rule 13q-1. Together, the combined scope of EU and U.S. laws on mandatory disclosures are expected to "cover 90 percent of the world's major international extractive companies," and signify the continuing consolidation of international transparency promotion efforts. Similar measures have been contemplated or implemented in a number of other jurisdictions worldwide.[4]

WHO IS SUBJECT TO THE DISCLOSURE REQUIREMENTS?

The Accounting Directive covers public and private limited liability companies registered in the European Economic Area ("EEA"), and sets out the new reporting regime in Chapter 9. The entirety of those disclosure requirements are incorporated by reference in the Transparency Directive so as to cover companies listed on the regulated markets, even if they are not registered in the EEA and are incorporated in a third country.

Chapter 9 of the Accounting Directive directs "large undertakings and all public interest entities active in the extractive industry or the logging of primary forests to prepare and make public a report on payments made to governments on an annual basis." A "**large undertaking**" is defined as a business that, on its balance sheet date, exceeds two of the three following criteria: (i) balance sheet assets of €20 million; (ii) net turnover of €40 million; (iii) average number of 250 employees during the financial year.[5] However, disclosures also are required by "**public interest entities**" of any size, namely, limited liability companies that are: (i) admitted to trading on an EU regulated market; (ii) credit institutions; (iii) insurance undertakings; or (iv) so designated by Member States because of their significant public relevance.

Disclosure obligations will attach to a large undertaking or public entity that is "active in the extractive or logging of primary forest industries" as described below. The disclosure rules apply irrespective of whether or not the activity is a primary business for the company.

Under the Transparency Directive, issuers of any size that are "active in the extractive or logging of primary forest industries," as defined in the Accounting Directive, are also subject to the Chapter 9 regime.

There are several notable features to the foregoing requirements:

- **Parent-Subsidiary and other "Controlled" Undertakings:** Chapter 9 provides that "a parent undertaking is considered to be active in the extractive industry or the logging of primary forests if any of its subsidiary undertakings are active," regardless of whether those subsidiary undertakings are registered in third countries. Subsidiary undertakings are defined as "undertaking[s] controlled by a parent undertaking, including any subsidiary undertaking of an

[4] *Natural Resource Corruption Dealt a Blow by New EU Transparency Rules*, Press Release, Transparency International (April 9, 2013). E.g. As of June 2010, Hong Kong has enforced the New Rules for Mineral Companies establishing country-by-country reporting for all petroleum and mineral companies and listed issuers on the Hong Kong Stock Exchange. Prime Minister Stephen Harper has also announced that Canada will adopt new mandatory reporting standards for payments made to foreign and domestic governments by Canadian companies in the extractive sector. *See*, "Harper announces new transparency rules for energy, mining," *CBC News* (June 12, 2013).

[5] The same criteria apply to define a "large group" (i.e., groups consisting of parent and subsidiary undertakings to be included in a consolidation) where, on a consolidated basis, two of the three criteria are exceeded on the balance sheet date of the parent undertaking.

ultimate parent undertaking" - a potentially broad category that could include, in certain cases, joint ventures, minority-owned undertakings, and undertakings managed on a unified basis by a parent undertaking, or other scenarios where one undertaking exercises a dominant influence over another.

- **Consolidated Reporting:** A parent undertaking is required to include controlled affiliates in its consolidated financial statements (subject to certain limited exceptions set forth in the Accounting Directive) and will also be required to make a consolidated report that includes any payments made to governments by it and its controlled affiliates in connection with extractive or logging activities.

  The potential ways in which the new reporting regime can impact undertakings are not readily obvious, including:

  - An issuer, large undertaking or public entity that is subject to the laws of a Member State and that is required to prepare a consolidated financial report pursuant to the Accounting Directive, may find itself subject to the disclosure requirement solely on account of its joint venture, private equity holding, or foreign subsidiary engaging in any kind or level of extractive or logging activity that is covered by the Chapter 9 reporting regime.
  - A subsidiary undertaking that is subject to the disclosure requirement must draw up a report for payments to governments that it itself has made, if those payments have not been included in a consolidated report (i.e., if its parent undertaking is not required to prepare consolidated financial statements pursuant to the Accounting Directive and/or is not subject to the laws of a Member State). A subsidiary undertaking preparing a disclosure report on its own behalf may face challenges in order to avoid the unwanted disclosure of information concerning a parent undertaking.

"UNDERTAKINGS ACTIVE IN THE EXTRACTIVE INDUSTRIES OR THE LOGGING OF PRIMARY FORESTS"

Article 36 of the Accounting Directive defines an "undertaking active in the extractive industry" as "an undertaking with any activity involving the exploration, prospection, discovery, development, and extraction of minerals, oil, natural gas deposits or other materials, within the economic activities listed [...]," which includes:

- mining of certain metals and minerals;
- extraction of crude petroleum and natural gas;
- quarrying;
- extraction of peat and salt; and
- operation of gravel and sand pits.

That definition is virtually unchanged from the Commission's original proposal but for the addition of "prospecting." Unlike in SEC Rule 13q-1, processing, export, and the acquisition of licenses are not part of the specified activities of the Accounting Directive. In addition, although the Directive is not entirely clear on this point, it is unlikely that ancillary or preparatory activities (e.g., manufacture of machinery used in the extraction of oil) are intended to be covered.[6]

[6] In particular, "support activities" for extraction, mining and quarrying are excluded from the statutory list of economic activities referenced in the Article 36 definition. (Division 09 of Annex I to Regulation (EC) No 1893/2006, which immediately follows Divisions 05 to 08 as referred to in the Article 36 definition, pertains to "mining support services"; "support activities for petroleum and natural gas extraction"; and "support activities for other mining and quarrying.")

The logging of primary forests is defined to include "naturally regenerated forest of native species, where there is no clearly visible indication of human activities and the ecological processes are not significantly disturbed."

DISCLOSURES REQUIRED BY THE ACCOUNTING DIRECTIVE

Parties that are subject to the Chapter 9 disclosure obligations are required to prepare and publish an annual report containing the following information in relation to the covered extractive or logging activities:

- the total amount of payments, including payments in kind, to each government within a financial year;
- the total amount per type of payment, including payments in kind, to each government within a financial year;
- whenever the foregoing payments have been attributed to a specific project, the amount per type of payment, including payments in kind, for each such project within a financial year and the total amount of payments for each such project.

Whereas the Commission's original proposal had provided that reporting would be required only when "material to the recipient government," the agreed compromise text contains no reference to materiality. Instead, "any payment, whether made as a single payment or as a series of related payments" must be included in the report if it is €100,000 or more within a financial year. The Accounting Directive provides further clarification into the terms "payment"; "project"; and "government":

- "Payment": Refers to amounts paid, whether in money or in kind, for the covered extractive or logging activities, and in the following types:
  - production entitlements;
  - taxes levied on the income, production or profits of companies, excluding taxes levied on consumption such as value added taxes, personal income taxes or sales taxes;
  - royalties;
  - dividends;
  - signature, discovery and production bonuses;
  - license fees, rental fees, entry fees and other considerations for licenses and / or concessions; and
  - payments for infrastructure improvements (such as roads and railways), if such payments have been made to further the covered extractive or logging activities.

  Amendments made to the original proposal have resulted in a list of covered payment types that is similar to those covered by SEC Rule 13q-1.

  Parties subject to the disclosure requirement must include in their reports any *non-ordinary* dividend payments paid to a host government, such as any dividends paid in lieu of production entitlements or royalties. According to the recitals to the Accounting Directive, such companies will not be required to disclose dividends paid to a host government as a common or ordinary

shareholder of that undertaking as long as the dividend is paid to the government under the same terms as to other shareholders.

- "Project": Article 36(4) of the Accounting Directive defines the term "project" to mean the operational activities that are governed by a single contract, license, lease, concession or similar legal agreements and that form the basis for payment liabilities with a government. "Project" will also apply to "substantially interconnected agreements," which refers to a set of legal agreements that are operationally and geographically integrated with substantially similar terms.
  - The Directive allows for entity-level reporting in a similar manner to SEC Rule 13q-1. Payments made by the undertaking for obligations levied at the entity level may be disclosed at the entity level rather than the project level.
- "Government": The Chapter 9 reporting extends to payments made to any national, regional, or local authority of a Member State or of a third country. This includes a department, agency or undertaking controlled by that authority.

NO EXCEPTION FOR CONTRARY FOREIGN LAWS

Chapter 9 contains no exception from its disclosure requirements for payments to governments even if there are laws in the country of extraction or logging forbidding such disclosures. The Accounting Directive also does not indicate a possibility for non-reporting where contract provisions prohibit the required disclosures. Affected companies may wish to consider ensuring that contractual confidentiality provisions clearly allow for disclosures to be made when required by law.

EXEMPTION FOR "EQUIVALENT" THIRD COUNTRY REPORTING REQUIREMENTS

A significant addition to the original proposal is an exemption from Chapter 9 disclosure requirements when a company complies with third country reporting requirements that are deemed to be equivalent to those in Chapter 9. The Accounting Directive empowers the Commission to identify and apply the criteria for assessing the equivalence of third country reporting requirements, and stipulates certain mandatory criteria that must be considered in the Commission's evaluation process. Companies that prepare and make public a report according to equivalent third country reporting requirements will be required to publish that report in accordance with EU publication rules. Such companies will otherwise be exempt from all other Chapter 9 requirements.

A preliminary assessment of the mandatory criteria to be applied by the Commission supports that SEC Rule 13q-1 could potentially constitute an equivalent reporting regime. However, that view may be undercut by EU legislators' oft-expressed desire for the Chapter 9 regime to surpass extant efforts at promoting transparency. Thus, companies should stay apprised of how - and when - the Commission finally implements these provisions of the Accounting Directive.

ANTI-EVASION PROVISION AND PENALTIES

Article 38(4) of the Accounting Directive specifies that the required disclosures shall reflect the substance, and not the form, of the payment or activity concerned. Thus, for example, undertakings are prohibited from re-characterising or artificially aggregating or splitting payments and activities so as to avoid disclosures that would otherwise apply. More generally, Recital 4(a) underscores that the scope of the Directive is based on principles so as to prevent undertakings from structuring their group entities within or outside the EU in order to exclude themselves from its scope.

Chapter 9 and the Directive both leave it to individual Member States to provide for penalties applicable to infringements of the new disclosure requirements.

EFFECTIVE DATE AND NEXT STEPS

Member States must adopt the Accounting Directive and Transparency Directive within two years of its entry into force, though they may provide that the transposed rules shall apply to financial statements for financial years beginning on January 1, or during the calendar year, of the year following the transposition deadline. In the meantime, affected undertakings should develop a strategy for implementing the new requirements. Further legislative developments also merit close monitoring, including the Commission's evaluation of equivalent reporting requirements and the transposition of the Directives into national laws.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our white collar practice group:

David Lorello	+44.(0)20.7067.2012	dlorello@cov.com
Suzanne Siu	+44.(0)20.7067.2019	ssiu@cov.com

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