

## ADVISORY | Securities

July 3, 2013

### D.C. DISTRICT COURT VACATES SEC'S RESOURCE EXTRACTION PAYMENT RULE

On July 2, 2013, the U.S. District Court for the District of Columbia vacated Rule 13q-1 under the Securities Exchange Act of 1934 (“Exchange Act”), the SEC’s resource extraction payment rule.<sup>1</sup> By vacating the rule, the District Court has dealt a blow to the SEC’s rulemaking efforts under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), efforts which the SEC has said are among its highest priorities. The Court’s ruling and its impact on public companies is discussed below.

#### BACKGROUND

On August 22, 2012, the SEC adopted Rule 13q-1 to implement Section 1504 of the Dodd-Frank Act. Section 1504 directed the SEC to issue rules requiring disclosure of certain payments by resource extraction issuers.<sup>2</sup> Section 1504 specified that the SEC’s rulemaking was, “[t]o the extent practicable,” to support the U.S. government’s commitment to international transparency efforts relating to the commercial development of oil, natural gas or minerals.<sup>3</sup>

Rule 13q-1 would have required resource extraction issuers to publicly disclose, in reports filed with the SEC, beginning in 2014, the type and amount of payments made to foreign governments or the Federal government for the purposes of the commercial development of oil, natural gas or minerals. On October 10, 2012, the American Petroleum Institute and certain other trade associations challenged the rulemaking in the U.S. District Court for the District of Columbia on the basis that, among other arguments, the rulemaking was arbitrary and capricious under the Administrative Procedure Act (“APA”) and violated the First Amendment.

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<sup>1</sup> *American Petroleum Institute, et al. v. Securities and Exchange Commission and Oxfam America, Inc.*, No. 12-1668 (D.D.C. Jul. 2, 2013).

<sup>2</sup> See *Disclosure of Payments by Resource Extraction Issuers*, Rel. No. 34-67717 (Aug. 22, 2012) (“Adopting Release”). The text of Rule 13q-1 is included in the Adopting Release, which is available on the SEC’s website at <http://www.sec.gov/rules/final/2012/34-67717.pdf>.

<sup>3</sup> The principal international transparency initiative in this area is the Extractive Industries Transparency Initiative (“EITI”). In connection with the EITI, the EU has recently approved a directive that, once fully implemented by its member countries, will require that companies listed on stock exchanges in those countries make public disclosures regarding their payments to foreign governments in connection with their commercial development of oil, natural gas or minerals. See, e.g. 8328/13 (Apr. 12, 2013) (“the Accounting Directive”); 9841/13 (May 23, 2013). For more information, see “EU Agrees On Disclosure Rules For Extractive And Logging Industries”, publicly available at <http://www.cov.com/files/Publication/2c5f1ad6-f0fd-4edc-b11b-58dd9e358af0/Presentation/PublicationAttachment/efeeef7d-599c-4e5a-9d9d-62d67b04a31c/EUAgreesonDisclosureRulesforExtractiveandLoggingIndustries.pdf>

## THE COURT'S RULING

The Court vacated Rule 13q-1 based on two “substantial errors” by the SEC, namely, its decisions to (i) require that companies “publicly” file the disclosures required by the rule and (ii) mandate disclosure even if such disclosure would violate applicable local law.

With respect to (i), the Court focused on the fact that the statute contains no explicit instruction that the required disclosures be made in a “public” filing. More specifically, the Court noted:

[The statute] says nothing about public filing of these reports. To state the obvious, the word “public” appears nowhere in this provision. The statute speaks of “disclosure” and “an annual report,” not “public disclosure” and not a “publicly filed annual report.” Nor does the phrase “annual report” command public filing... More instructive still, the public availability requirement is narrower than the underlying disclosure. Section 13(q)(3) provides: “To the extent practicable, the Commission shall make available online, to the public, a compilation of the information required to be submitted under the rules issued under [the annual report provision,] paragraph (2)(A).” 15 U.S.C. § 78m(q)(3)(A). The public availability, then, is limited to “a compilation of the information,” and is required only “[t]o the extent practicable.”

Regarding (ii), the Court criticized the SEC’s failure to exempt disclosure of payments when such disclosure would violate laws in foreign jurisdictions, stating that:

[T]he Commission impermissibly rested on the blanket proposition that avoiding all exemptions best furthers section 13(q)’s purpose. It did not consider whether a certain country or certain issuer that represents a high portion of the burden on competition and on investors is sufficiently central to that purpose to make an exemption unwarranted... The Commission undertook no [...] specific analysis, however, instead focusing heavily on the statute’s apparent purpose—a purpose it conceived more broadly than the statutory text, which emphasizes practicability. Averse to sacrificing any of the section 13(q) aims no matter the cost, the Commission abdicated its statutory responsibility to investors.

For these reasons, the Court vacated the rule. The Court did not address the First Amendment or other APA arguments made by the plaintiffs, but noted “questions remain about other aspects of the Rule.”

## IMPLICATIONS

The Court’s decision will have several important implications.

- **The SEC may appeal the decision.** The SEC has 60 days to appeal the decision, and, if it does, the results of any such appeal will have some bearing on the future course of rulemaking under Section 1504.
- **In all events, the SEC will have to do further rulemaking.** If the SEC successfully appeals the decision, some adjustment to the effective date of Rule 13q-1 would seem likely, if only to accommodate the delays and uncertainties brought on by the litigation. On the other hand, assuming any SEC appeal were unsuccessful, the SEC will have to start a new rulemaking process given the continued legislative imperative in Section 1504, which was not at issue in the litigation. That would require the SEC to publish a proposed rule, allow interested parties to submit comments on the proposed rule and then approve the proposal following the comment period. Any new rule proposal will also be the subject of further economic analysis by the SEC’s

Division of Economic and Risk Analysis. While all of that would be somewhat open-ended, given the high priority placed on Dodd-Frank Act rulemaking by SEC Chair Mary Jo White, we would expect the SEC to undertake these steps with a sense of urgency.

- **In the meantime, public companies in the resource extractive industry will not be required by the SEC to publicly disclose payments to governments.** By vacating Rule 13q-1, the Court has effectively removed it from the Federal Register. As a result, issuers that had been compiling information in contemplation of Rule 13q-1 may suspend their efforts for the time being.<sup>4</sup>
- **The SEC and other agencies will need to pay close attention to their analyses in their respective rulemaking processes.** Although the Court did not invalidate the rule based on any inadequacy in the SEC's cost-benefit analysis, the plaintiffs made claims to that effect. To the extent that this case bolsters further challenges to SEC rules, the decision will impact future rulemakings by the SEC. And this will have a ripple effect on rulemakings by other Federal agencies. For instance, in its opinion, the Court suggested that future rulemakings by the SEC should be accompanied by substantial statutory and cost-benefit analyses. That would suggest close scrutiny of any SEC cost-benefit analysis for any follow-on rule under Section 1504 that does not contain a carve-out for payments in countries where disclosure is prohibited by local law.
- **The impact of this decision on the pending legal challenge to the conflict minerals reporting rules is unclear.** Like the resource extraction payment rule, conflict minerals reporting rules adopted by the SEC under Section 1502 of the Dodd-Frank Act are being challenged in the U.S. District Court for the District of Columbia. That challenge involves some of the same arguments made to challenge to the resource extraction payment rule. The resource extraction payment rule is relatively narrow and fact-specific. Also, the statutory mandate for the conflicts minerals rules is much more prescriptive than that for the resource extraction payment rule. But, at a minimum, this case is another in a growing body of law which casts SEC rulemaking efforts in an unfavorable light that invites more rather than less judicial scrutiny.

## CONCLUSION

This decision deals a blow to the SEC's efforts to fulfill its obligations under the Dodd-Frank Act. It also will cast a shadow over future rulemakings by the SEC, and other agencies, whether under the Dodd-Frank Act or other legislation such as the JOBS Act. The decision, however, will not end the debate regarding payments to governments by companies in the resource extractive industry. First, the SEC will have to decide whether to appeal the decision, and if it does, it may persuade the Court of Appeals for the D.C. Circuit to overturn the lower court decision. Second, if it doesn't appeal, or if the appeal is unsuccessful, the SEC presumably will have to repropose the resource extraction payment rule, which could mean that companies eventually will become subject to the same (or a substantially similar) rule. Third, the resource extraction payment rule is part of a larger effort to obtain more information about payments to foreign governments by companies in the resource extractive industry. This all means that more disclosures regarding these activities will be required in one way or another.

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<sup>4</sup> This doesn't mean, however, that such information will not be required by other authorities. Because the U.S. is a signatory to the Extractive Industries Transparency Initiative, for instance, other Federal agencies, including the Department of the Interior, may reach out to obtain information that is similar in nature to the information sought by Section 1504 and Rule 13q-1. In addition, U.S. companies in the extractive industry that are listed on foreign exchanges, particularly those listed on exchanges in the EU, may soon become obligated to disclose their payments to foreign governments as a result of the EU's recent adoption of disclosure rules that are modeled after Section 1504.

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