

2015 RYDER SCOTT RESERVES CONFERENCE

LEGAL ISSUES IN THE LOW PRICE ENVIRONMENT

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- SEC Comment Letters – Process, Tips, and Trends
- Low Energy Prices Are Here – What is the Legal Fallout?
- Questions

SEC COMMENT LETTER PROCESS

- **SEC's Division of Corporation Finance**
 - Reviews filings under Securities Act and the Exchange Act
 - Monitors/enhances compliance with disclosure/accounting requirements
- **Division concentrated on disclosures that appear to**
 - Conflict with SEC rules or applicable accounting standards
 - Be materially deficient in explanation or clarity
- **Division does not evaluate the merits of any transaction or determine whether an investment is appropriate**
- **Division's 12 Assistant Director offices (AD Offices) have specialized industry, accounting and disclosure expertise**
 - Each AD Office has about 25-35 staff members
 - Senior staff consists of Associate Director, Assistant Director, Legal Branch Chief, Senior Assistant Chief Accountant and Accounting Branch Chiefs
- **AD Office 4 - Natural Resources - Petroleum Engineers**

- Sarbanes-Oxley Act requires review of reporting companies once every 3 years
 - Significant number of companies reviewed more frequently
- Sarbanes-Oxley Act Section 408 factors for review of Exchange Act filings
 - Material restatements of financial results (Form 8-K under Item 4.01 (Changes in Accountants) or Item 4.02 (Non-Reliance on Previously Issued Financial Statements))
 - Significant volatility in stock price as compared to other issuers
 - Largest market capitalizations
 - Emerging companies with disparities in price to earnings ratios
 - Operations significantly affecting a material sector of the economy
 - Any other factors that the SEC may consider relevant

- Selective review of transactional filings: public offerings, business combination transactions, and proxy solicitations
- No review - Form S-3ASR (for WKSIs) and Form S-8 (for benefit plans) effective upon filing
- Normally reviewed – Form S-1 (for IPOs) and Form S-4 (for business combinations)
- Review criteria is not publicly disclosed “to preserve the integrity of the selective review process” and varies for Securities Act or Exchange Act filing
- Many filing reviews do not result in comments

- Filing assigned to AD Office by industry (based on SIC code)
- Preliminary screening review conducted by an SEC examiner and a staff accountant
 - No further review is necessary or further review is warranted
- Scope of further review will depend on many factors
 - Full review - examine the entire filing – for Securities Act filings, can result in review of Exchange Act filings incorporated by reference
 - Financial statement review - examine the financial statements and related disclosure
 - Targeted issue review - examine the filing for one or more specific items of disclosure
- Staff can focus attention wherever they feel it is needed

- **Timing of initiation of review by Staff**
 - Exchange Act filings – up to a year after filing is made
 - Preliminary proxies and non-S-4 merger proxies – 10 calendar days or company can print and mail
 - Securities Act filings
 - Typically 2 to 5 business days after public filing or initial confidential submission to determine review status
 - If reviewed, comment letter typically issued within 30 days (but can be up to 40 to 50 days)
- **Review typically made by first level SEC examiner and staff accountant and (in nearly all cases) by second SEC examiner and staff accountant ("reviewers")**
- **Comment letter - numbered list of Staff questions/comments generally in the order in which information is presented in the filing**

- Generally 3 types of comments made by SEC staff
 - Substantive comments requesting revision/clarification of specified disclosures
 - Requests for supplemental information so Staff can better understand the disclosure
 - Comments regarding technical or procedural matters, such as filing documents as exhibits (i.e., reserve reports)
- Review may involve more than one round of comments from Staff and responses from the company
- Review may also involve teleconferences with Staff to discuss and resolve the comments and responses

- **No definitive timetable for review; timing factors include:**
 - Time for company to prepare letter and respond
 - Amount of revised disclosures and/or supplemental information
 - Time for Staff to review and respond
 - Number of rounds of comment letters and response letters
 - Response required within a specified period of time or by a specified date
- **SEC publicly releases comment letters and response letters**
 - Available via EDGAR at least 20 business days after review
 - EDGAR tag - "upload" (comments) and "corresp" (responses)
 - If confidential treatment is granted, only non-confidential portions are made publicly available
- **Companies generally try to resolve comments quickly, particularly with respect Securities Act filings.**
 - Accelerated filers, large accelerated filers and WKSIs must disclose existence of material unresolved SEC comments in Form 10-Ks

- Comment letter circulated to persons responsible for responding to comments, which may include (depending on the company and the nature of the comments):
 - Board of Directors/Audit Committee
 - CFO/controller and other members of department
 - Chief reservoir engineer and other members of department
 - General counsel and other members of department
 - Outside auditors
 - Outside counsel
 - Outside reservoir engineers
 - Other personnel if expertise is required
- Working group discusses/splits up comments and agrees on responses, and the company or its outside counsel prepares a response letter
- Response letter must address each of the SEC's comments

- Response letter is filed with SEC via EDGAR but is not immediately publicly available
 - Supplemental information attached as an exhibit does not need to be filed via EDGAR; can be delivered by fax/overnight courier
 - If supplemental information is to be kept confidential, company should simultaneously request that SEC return it after review
- Staff reviews response letter and, if they have additional comments, provides another comment letter
- Process continues until SEC is satisfied and has no additional comments; process can take many weeks
- If comment letter includes deadline, company must deliver its response within deadline or request an extension from SEC

- Two response letters
 - “Redacted” version filed via EDGAR
 - Unredacted version delivered by fax, overnight courier or messenger
- SEC’s determination on the confidential treatment request (CTR) not made unless third party tries to obtain redacted information under Freedom of Information Act
- FOIA Office asks for company confirmation of CTR within 10 calendar days; company confirmation should discuss:
 - Reasons why information should be kept confidential
 - Any applicable statute or regulation
 - Any prior determination of the confidentiality of the information
 - Adverse consequences that would result from disclosure
 - Measures taken to protect the confidentiality
 - Whether company's competitors can easily obtain the information
- CTR expires in 10 years unless the company renews

- Generally, SEC Staff has final say; however, company can have comments/disagreements on comments reconsidered
- Non-accounting/reserve engineer comments:
 - Examiner and reviewer
 - Legal Branch Chief
 - Assistant Director or Associate Director
 - Deputy Director or Director
- Accounting/reserve engineer comments:
 - Staff accountant, reviewing accountant and reserve engineer
 - Accounting Branch Chief
 - Senior Assistant Chief Accountant
 - Division of Corporation Finance's Office of the Chief Accountant
 - Assistant Director or Associate Director
 - Deputy Director or Director
 - SEC's Office of Chief Accountant (not Corp. Fin. Office)
- Exhaust lower levels before appealing to higher levels

- Assemble team and assign leader to coordinate comments
- Determine due date and request extension if necessary
 - Securities Act filings - generally no deadline, but filing will not be declared effective until comments are resolved
 - Exchange Act filings - generally a deadline of 10 business days
 - Staff typically grants written requests for reasonable extensions
- Analyzing and responding to comment letter
 - Determine if comments are understandable; contact Staff for clarification
 - Complying with Staff's request can quickly resolve comments
 - Review publicly available comment letters for prior Staff positions
 - Exchange Act filings – delivery of revised/clarified language and agreement to include language in future Exchange Act filings usually works (instead of amending previously filed documents)
 - Comment may require supplemental information
 - Address the comment as fully as possible without providing irrelevant information; too much disclosure can lead to additional comments; response formulation more art than science ...?

- **Difficult comments may require phone calls/internal appeals**
 - Limit phone calls to one or two comments
 - Attempt to resolve comments at lowest level possible
 - Advise lower level staff of appeal to a higher level
 - Note that a difficult comment has likely been reviewed by supervisors and support offices as Staff knows when it is dealing with a difficult comment and that it may be appealed
 - Act professionally and treat the Staff with respect
- **Formatting of response letter**
 - Numbering format should be the same as the comment letter
 - Repeat Staff's comment and then list company's response
 - If revised disclosure is being provided in an amended filing, letter should specifically disclose location of revised disclosure
 - Standard practice is provide Staff with redlined hardcopies of revised filings as a courtesy
 - Delivery of separate overnight packages for each relevant Staff member can expedite review

- Recent comment letter survey conducted by Ryder Scott reveals:
 - Reserves-related comments are increasing
 - Comments often cover multiple years
 - Proved undeveloped reserve (PUD) related comments constitute over one-third of all reserve related questions
 - PUD related comments typically cover PUD development, PUD capital expenditures and the 5 Year Rule
 - Comments in these areas tend to be fact specific and often involve requests for supplemental information over multiple years
- With declines in commodity prices and corresponding announcements of reductions in capital spending and drilling activity, companies should expect the Staff to continue to focus on PUD development, PUD capital expenditures and the 5 Year Rule

- Item 1203 of Regulation S-K (Disclosure requirement)
 - (a) Disclose the total quantity of proved undeveloped reserves at year end
 - (b) Disclose material changes in proved undeveloped reserves that occurred during the year, including proved undeveloped reserves converted into proved developed reserves
 - (c) Discuss investments and progress made during the year to convert proved undeveloped reserves to proved developed reserves, including, but not limited to, capital expenditures
 - (d) Explain the reasons why material amounts of proved undeveloped reserves in individual fields or countries remain undeveloped for five years or more after disclosure as proved undeveloped reserves.

➤ Rule 4-10(a) of Regulation S-X

(22) Proved oil and gas reserves. Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation. The project to extract the hydrocarbons must have commenced or the operator must be reasonably certain that it will commence the project within a reasonable time.

...

(24) Reasonable certainty. If deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate....

➤ Rule 4-10(a) of Regulation S-X

(31) *Undeveloped oil and gas reserves* are reserves of any category that are expected to be recovered from new wells on undrilled acreage or from existing wells where a relatively major expenditure is required for recompletion.

(i) Reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances.

(ii) Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years unless the specific circumstances justify a longer time.

(iii) Under no circumstances shall estimates for undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the same reservoir or an analogous reservoir, as defined in paragraph (a)(2) of this section, or by other evidence using reliable technology establishing reasonable certainty.

➤ SEC Compliance and Disclosure Interpretations

- Question 131.03: In the definition of "undeveloped oil and gas reserves," what "specific circumstances" would justify a time period longer than five years to begin development of those reserves?
 - Answer: Although several types of projects — such as constructing offshore platforms and development in urban areas, remote locations or environmentally sensitive locations — by their nature customarily take a longer time to develop and therefore often do justify longer time periods, this determination must always take into consideration all of the facts and circumstances. No particular type of project per se justifies a longer time period, and any extension beyond five years should be the exception and not the rule.

[Continued on next side]

Factors that a company should consider in determining whether or not circumstances justify recognizing reserves even though development may extend past five years include, but are not limited to, the following:

- The company's level of ongoing significant development activities in the area to be developed (for example, drilling only the minimum number of wells necessary to maintain the lease generally would not constitute significant development activities);
- The company's historical record at completing development of comparable long-term projects;
- The amount of time in which the company has maintained the leases, or booked the reserves, without significant development activities;
- The extent to which the company has followed a previously adopted development plan (for example, if a company has changed its development plan several times without taking significant steps to implement any of those plans, recognizing proved undeveloped reserves typically would not be appropriate); and
- The extent to which delays in development are caused by external factors related to the physical operating environment (for example, restrictions on development on Federal lands, but not obtaining government permits), rather than by internal factors (for example, shifting resources to develop properties with higher priority). [Oct. 26, 2009]

➤ SEC Compliance and Disclosure Interpretations

- Question 131.04: The definition of "undeveloped oil and gas reserves" requires that the company have adopted a development plan with respect to the reserves. What constitutes adoption of a development plan?
 - Answer: The mere intent to develop, without more, does not constitute "adoption" of a development plan and therefore would not, in and of itself, justify recognition of reserves. Rather, adoption requires a final investment decision. [Oct. 26, 2009].
- Question 131.05: Would a company's decision to slowly develop a field in order to extend its economic life justify recognizing proved undeveloped reserves in the field beyond five years?
 - Answer: No. The company should not recognize undeveloped areas as proved undeveloped reserves if it does not anticipate initiating development in those areas within five years. [Oct. 26, 2009].

➤ Final observations

- Disclosure rules provides roadmap for additional inquiry
 - PUDs remaining undeveloped for 5 years or more
 - Conversion rates (range from 15% to 25%)
 - Investments and progress to covert PUDs, including capital expenditures
 - Lease expirations – PUDs scheduled to be developed after expiration
- Impact of reduced commodity prices/capital spending/drilling activity will affect ability to develop within 5 years
- Ultimately leads to questions about the development plan, reasonable certainty and final investment decision, and the company's justification for booking PUDs

LOW ENERGY PRICES ARE HERE – WHAT IS THE LEGAL FALLOUT?

- More lawsuits
- What does that mean for you?
 - More subpoenas for documents and depositions

- Tips on what to do if you are served with a subpoena
 - Documents or depositions...or both
 - Note the “due date”
 - Get legal counsel involved
 - Protections from undue burden and expense
 - Advice regarding scope of collection and production
 - Preservation of all legal rights
 - For depositions – preparation is important

- Industry consolidations, mergers, bankruptcies
- What does that mean for you?
 - Layoffs or changes in employment status

- Tips on what to do if your employment status changes
 - Non-compete agreement
 - Trade secrets
 - Get legal counsel involved
 - Advice regarding legal rights and duties
 - A “clean” separation
 - Preserve data

QUESTIONS?