

Regulation Analyst Certification

First, it was the Chief Executive Officer and Chief Financial Officer who were required to certify reports. Now, it is research analysts. The SEC has issued new rules for certification of research reports by brokers, dealers and certain persons associated with brokers or dealers. Under these rules, each research report must include a certification stating that the views in the report accurately reflect the personal views of the research analyst primarily responsible for the content of the report. The rules also require disclosure of whether or not the research analyst received compensation or other payments in connection with his or her specific recommendations or views. Finally, the rules require brokers/dealers to obtain periodic certifications by research analysts in connection with their public appearances. Release No. 33-8193 (February 20, 2003) <http://www.sec.gov/rules/final/33-8193.htm>. The rules are effective as of April 14, 2003.

Who is covered?

Regulation AC is applicable to brokers, dealers and persons associated with a broker or dealer, that is "covered persons." In its adopting release, the SEC confirmed that investment advisers and banks are subject to Regulation AC if they are covered persons.

Associated persons are not covered persons under Regulation AC, however, if (i) they have no officers or employees in common with the broker or dealer, and (ii) the broker or dealer maintains and enforces written policies and procedures reasonably designed to prevent the broker or dealer or any of its controlling persons, officers or employees from influencing the activities of research analysts and the content of research reports prepared by the covered person. A broker or dealer is required to notify its covered persons as to whether the covered person has any officers (or persons performing similar functions) or employees in common with the broker or dealer who can influence the activities of research analysts or the content of research reports and whether the broker or dealer maintains and enforces written policies and procedures to prevent impermissible influence over research activities.

Regulation AC will not apply to the publisher of any newspaper, news magazine or business or financial publication of general and regular circulation that is not registered or required to be registered with the SEC as a broker or dealer or investment adviser. In addition, Regulation AC does not cover investment advisers that are prohibited from registering as such with the SEC and not otherwise registered (or required to be registered) as brokers/dealers.

What certifications are required?

Research Reports. A broker, dealer or covered person that publishes, circulates or provides a research report prepared by a research analyst to a U.S. person in the United States must include in that research report a clear and prominent certification by the research analyst attesting as to the following:

- that all of the views expressed in the research report accurately reflect the research analyst's personal views about all of the subject securities or issuers; and

- whether or not any part of his or her compensation was, is, or will be related to the specific recommendation or views contained in the research report.

If the compensation certification is answered affirmatively, the source, amount and purpose of the compensation must be identified, and an additional disclosure must be included in the research report indicating that the compensation could influence the recommendations or views expressed in the research report.

In its proposing release, the SEC had noted that Regulation AC does not preclude a research analyst from providing otherwise permissible services to his or her firm's investment banking department, and it does not prohibit research analysts generally from receiving compensation for covering issuers or for preparing research reports. In addition, Regulation AC is not intended to address compensation based on the accuracy or performance of the recommendation or views expressed by the research analyst in the research report. Instead, Regulation AC focuses on disclosure where compensation is related to the specific recommendations or views expressed by the research analyst in the research report.

Public Appearances. In its proposing release, the SEC had requested comment on what, if any, disclosures should be required during public appearances by research analysts. Commenters generally opposed requiring certifications during the public appearance. Instead of this, in the final rules, the SEC adopted a quarterly certification system for public appearances. Under this system, generally, a broker or dealer that publishes, circulates or provides a research report to a U.S. person in the United States must make a record within 30 days after any calendar quarter in which the research analyst made a public appearance. The record must contain a statement by the research analyst attesting that

- the views expressed by the research analyst in all public appearances during the calendar quarter accurately reflected the research analyst's personal views at that time about any and all of the subject securities or issuers, and
- no part of the research analyst's compensation was, is, or will be related to the specific recommendations or views expressed by the research analyst in the public appearances.

If the broker or dealer does not obtain these statements from the research analyst, the broker or dealer must notify its examining authority and disclose in any research report prepared by the research analyst during the next 120 days that the research analyst did not provide the required statements.

A public appearance is any participation by a research analyst in a seminar, forum (including an interactive electronic forum), or radio or television or other interview, in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer.

Who is a research analyst?

A research analyst is any person who is principally responsible for the analysis of any security or issuer included in a research report. If more than one research analyst is primarily responsible for the content of a research report, each of them must provide the required certifications in the research report. Analysts who are not primarily responsible

for the content of a research report are not subject to the certification requirements of Regulation AC.

What if there is no identified research analyst?

A broker, dealer or covered person cannot avoid the certification requirements by removing the names of all analysts from a research report. The analyst or analysts primarily responsible for the report must provide the required certifications.

In certain circumstances a research report may not have an identified research analyst because the research report is based on the firm's quantitative or technical research model. In these circumstances, the firm itself may provide the certification that the views expressed in the research report accurately reflect the firm's quantitative or technical research model and that no part of the firm's compensation was, is, or will be related to the specific recommendations or views disclosed in the research report.

What is a research report?

A research report is a "written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision." This is consistent with the definitions in rules of the New York Stock Exchange and the National Association of Securities Dealers. Unlike those rules, however, Regulation AC applies not only to equity securities, but also to debt securities. A research report does not need to include a recommendation to be covered by Regulation AC.

As the SEC indicated in its adopting release, the following communications would not be research reports so long as they do not include an analysis of, or recommend or rate, individual debt or equity securities or issuers:

- reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index;
- reports commenting on economic, political, or market conditions;
- reports commenting on or analyzing particular types of debt securities or characteristics of debt securities;
- technical analysis concerning the demand and supply for a sector, index, or industry based on trading volume and price; and
- reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities.

The SEC also indicated in its adopting release that the following communications would generally not be research reports even if they did recommend or rate individual securities or companies:

- statistical summaries of multiple companies' financial data (including listings of current ratings) that do not include any analysis of individual companies' data;
- analyses prepared for specific persons or limited groups of fewer than 15 persons;

- periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions; and
- internal communications that are not given to customers.

What if the research report is a compendium report?

In a report covering multiple issuers, if each research analyst required to certify with respect to the views in the report can make the appropriate certifications required under Regulation AC, the broker or dealer may comply with Regulation AC by including one clear and prominent combined certification. The combined certification would be to the effect that, as to each issuer covered, the respective research analyst (or analysts) makes the appropriate certifications.

In its proposing release, the SEC had requested comment on whether Regulation AC should make allowances for compendium research reports covering six or more securities similar to the treatment under rules of the New York Stock Exchange and the National Association of Securities Dealers. These rules exempt a compendium report from certain disclosure requirements if the report directs readers to a toll-free number or postal address to write for the required disclosures. There was support for that approach among commenters. The SEC determined, however, that it would not adopt a similar system for compendium reports under Regulation AC because the Regulation AC certifications are more concise as compared to the certifications required by the New York Stock Exchange and the National Association of Securities Dealers.

How is third party research treated?

Regulation AC will not apply where a broker, dealer or covered person distributes research prepared by a third party research analyst whose employer satisfies certain independence criteria. The independence criteria provide that (i) the third party research analyst's employer does not have officers or employees in common with the broker, dealer or covered person distributing its research, and (ii) the broker or dealer has written policies and procedures designed to prevent the broker or dealer, its controlling persons, officers, and employees from influencing the activities of the third party research analyst and the content of his or her research reports. If a broker or dealer distributes the research of a third party that does not meet the independence criteria, the broker or dealer must confirm that the research report includes the certifications required by Regulation AC. Brokers or dealers that distribute third party research are not required to obtain the public appearance certifications with respect to public appearances by third party research analysts.

Does Regulation AC apply to foreign research?

A foreign person, located outside of the United States and not associated with a registered broker or dealer, who prepares a research report concerning a foreign security and provides it to a major U.S. institution in accordance with Rule 15a-6(a)(2) of the Securities Exchange Act of 1934, is exempt from the certification requirements of Regulation AC. In addition, in the case of a research analyst employed outside the United States by a foreign person located outside the United States, Regulation AC only applies to public appearances while the research analyst is physically present in the United States.

Does Regulation AC impose new liabilities?

The SEC received several comments requesting that it reiterate the position stated in its proposing release that Regulation AC does not impose new liability on research analysts or their firms. The SEC affirmed this position in the adopting release. Regulation AC does not alter any other existing obligation under the federal securities laws for research analysts or brokers/dealers; it formalizes and potentially adds rigor to research analysts' responsibilities to express their views truthfully.

Conclusion

Regulation AC is one part of a broad regulatory framework that is being constructed to address in more detail the practices and procedures of research analysts. The New York Stock Exchange and the National Association of Securities Dealers, the logical architects of this new framework, have each issued extensive new rules in this area. These rules first started in May 2002 and have been under review and adjustment since then. In addition, state prosecutors have been investigating research analyst practices at major investment banking firms. These investigations have resulted in one large settlement, the terms of which have been voluntarily adopted by many firms and may become generally applicable to other firms. Other more significant settlements with other investment banking firms have also been announced and will result in further requirements for research analysts. In this context, Regulation AC is more detail than design for a rapidly evolving regulatory framework.

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