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SEC Issues Final Rules on Regulation Analyst Certification

On February 20, 2003, the Securities and Exchange Commission (“SEC”) adopted Regulation Analyst Certification (“Regulation AC”) under the Securities Exchange Act of 1934 (the “Exchange Act”). See **SEC Release No. 33-8193** (<http://www.sec.gov/rules/final/33-8193.htm>). Regulation AC becomes effective April 14, 2003, and requires broker-dealers and certain associated persons who distribute research reports to obtain certifications from the research analyst or analysts primarily responsible for the content of the report. The broker-dealers are also required to obtain certifications and maintain records regarding research analysts’ public appearances. Regulation AC also imposes important new compliance responsibilities on foreign securities firms whose research is disseminated in the United States.

Certification Requirements

Regulation AC requires broker-dealers and their associated persons that are “covered persons” that publish, circulate or provide a research report to a U.S. person in the United States to include a certification by the research analyst primarily responsible for the content of the report. The certification by the research analyst must (i) attest that the views expressed in the report accurately reflect the analyst’s personal views about the subject securities or issuers, and (ii) disclose whether or not the analyst’s compensation was, is, or will be tied to the specific recommendations or views expressed in the report. If the analyst’s compensation is tied to the recommendation or views expressed, the analyst must further disclose the source and amount of such compensation, the purpose of the compensation, and that the compensation may influence the recommendation in the research report. The adopting release clarifies that the compensation disclosure requirement is intended to focus only on compensation related to a specific recommendation or view. The SEC has stated that disclosure is not required for compensation derived from the performance of a recommendation or for the performance of general duties in preparing the report. The certifications must be “clear and prominent,” meaning that the front page of the report must either contain the certification or the page numbers where the certifications can be found.

In addition, Regulation AC requires broker-dealers and covered persons to make and preserve records in connection with research analysts’ public appearances.”¹ Specifically, if a broker-dealer distributes a research report prepared by a research analyst employed by the broker-dealer or a covered person, the broker-dealer must make a record within 30 days after each calendar quarter in which the research analyst makes a public appearance. The record must

¹ A “public appearance” is any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a specific recommendation or offers an opinion concerning a security or an issuer.

include a written statement by the research analyst certifying (i) that the views expressed in each public appearance during the calendar quarter accurately reflect the research analyst's personal views, and (ii) that no part of his or her compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in the public appearance.

If a research analyst is unable to make the certification described above, then the broker-dealer must take the following actions:

- Make and preserve a record of a statement by the research analyst that he or she is unable to make the requisite certification and the reasons why.
- Disclose in all research reports by the research analyst for the next 120 days that the analyst did not provide the requisite certification and the reasons why (the 120-day period begins to run when the analyst notifies the broker-dealer of his or her inability to provide the written certification).
- Provide a copy of the research analyst's statement attesting to his or her inability to provide the requisite certification to the broker-dealer's designated examining authority.

Research Report Defined

Regulation AC deletes the recommendation element from the definition of "research report" to conform to Section 501 of the Sarbanes Oxley Act. A research report is any 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. It includes reports on both equity and debt securities.

Whether a writing constitutes a research report will turn on the specific facts and circumstances surrounding the communication. Acknowledging the broad nature of the definition, the SEC did provide examples of communications that would not be considered research reports. In general, these include communications regarding broad-based indices, general market or economic conditions, and technical analysis of a sector, index or industry, provided the writing contains no recommendation or analysis with respect to an individual security or issuer. Further, the SEC has stated that the following communications would not be considered research reports even if they 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.
- An analysis prepared for a specific person or a limited group of fewer than fifteen 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.
- Internal communications that are not given to customers.

Persons Required to Obtain Certifications

The obligation imposed by Regulation AC to obtain and include the certification falls upon any broker-dealer or covered person publishing, circulating or providing the research report to a U.S. person within the United States.² There is no requirement that the broker-dealer be registered with the Securities and Exchange Commission. As a result, any person who meets the definition of a broker-dealer under the Exchange Act and who distributes a research report may be subject to Regulation AC. Further, investment advisers, banks and foreign securities firms that are associated with broker-dealers are subject to certification requirements under Regulation AC if they would be considered covered persons.

Covered Person. A “covered person” is an associated person of a broker-dealer³ but does not include (i) certain control affiliates of the broker-dealer who meet independence requirements specified in the rule and (ii) an investment adviser not registered with the SEC as a federal covered adviser or as a broker-dealer. The independence requirements for a control affiliate to be excluded specify that the affiliate must have no officers or employees in common with the broker-dealer, and the broker-dealer must maintain and enforce written policies and procedures reasonably designed to prevent the broker-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 associated person. In such instances, analyst certifications are not required because the SEC believes the associated person possesses a sufficient level of independence from the broker-dealer distributing the research report.

Regulation AC requires broker-dealers to notify their associated persons that issue research reports as to whether the broker-dealer maintains and enforces such written policies and procedures in order to avoid instances where a research analyst might fail to certify because he/she incorrectly believes that the broker-dealer has established policies and procedures to prevent improper influence. Broker-dealers must also inform associated persons who issue research whether any officers or employees in common with the broker-dealer and a control affiliate are capable of influencing the activities of research analysts or the content of research reports, and, if so, the identity of those persons.

Application of Regulation AC to foreign research. Rule 15a-6 under the Exchange Act provides conditional exemptions from United States registration for foreign broker-dealers that engage in certain direct and indirect activities involving United States investors and securities markets, including the provision of research to United States persons. Specifically, paragraph (a)(2) of Rule 15a-6 provides an exemption from registration for a broker-dealer that furnishes

² U.S. Person is defined by Regulation S Rule 902(k) and includes among others, all residents of the United States, all legal entities organized within the United States, any account of a U.S. person managed or held by a foreign entity, and trusts for which a U.S. person is a trustee. The United States is defined as the United States of America, its territories and possessions, any State of the United States, and the District of Columbia.

³ The term "person associated with a broker or dealer" or "associated person of a broker or dealer" is defined in Exchange Act Section 3(a)(18) as any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer.

research reports to “major U.S. institutional investors,”⁴ provided certain conditions are met. In addition, under the interpretive position affirmed by the SEC in the release adopting Rule 15a-6, the SEC does not require the registration of a foreign broker-dealer that distributes research reports to United States persons—not just major institutional investors—through a registered broker-dealer, provided that, among other things, the registered broker-dealer prominently states on the research report that it accepts responsibility for its content, and all other contacts between the foreign broker-dealer and the customer are conducted in accordance with Rule 15a-6.

In general, non-registered broker-dealers providing research to United States persons under Rule 15a-6 must provide analyst certifications in distributed research reports in accordance with Regulation AC. However, a narrow exception was created for foreign persons located outside the United States and not associated with a registered broker-dealer that prepare and provide research on foreign securities to major U.S. institutions in accordance with the provisions of Rule 15a-6(a)(2). In these instances, the foreign person is excepted from the requirements of Regulation AC. In addition, where a research analyst is employed outside the United States by a foreign person located outside the United States, analyst certifications in connection with public appearances are only required while the research analyst is physically present in the United States.

Regulation AC would apply to all other instances in which a foreign non-registered broker-dealer furnishes research to United States persons pursuant to Rule 15a-6 or otherwise, including the provision of research to United States persons pursuant to the interpretive position affirmed in the Rule 15a-6 adopting release, as well as the provision of research to major U.S. institutional investors through an affiliated United States registered broker-dealer pursuant to Rule 15a-6(a)(2).

Persons Required to Provide Certifications

Regulation AC requires the broker-dealer to obtain the certifications from the research analyst that prepared the research report. A “research analyst” is defined as any natural person who is primarily responsible for the analysis of any security or issuer included in a research report. This definition is broader than that contained in any of the NYSE or NASD analyst conflict of interest rules or Section 501 of the Sarbanes Oxley Act, which each require the analyst to be associated with the broker-dealer. As a result, Regulation AC requires communications that constitute a research report prepared by any natural person and distributed by a broker-dealer to contain the certifications.

A limited exemption from the certification requirements of Regulation AC is provided to broker-dealers and covered persons with respect to certain reports prepared by “third-party research

⁴ The term “major U.S. institutional investor” is defined in Section 15a-6(b)(4) as a person that is (i) a U.S. institutional investor, as defined in Rule 15a-6(b)(7), that has, or has under management, total assets in excess of \$100 million; provided, however, that for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of any family of investment companies of which it is a part; or (ii) an investment adviser registered with the SEC under Section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of \$100 million.

analysts.”⁵ To be eligible for the exemption, the third-party research analyst’s employer cannot have officers or employees in common with the broker-dealer or covered person distributing the research. Further, the broker-dealer must have written policies and procedures designed to prevent the broker-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. Where a broker-dealer distributes the research of a third party that does not meet the independence criteria, however, the broker-dealer must fully comply with analyst certifications as required by Regulation AC.

Broker-dealers are not required to obtain public appearance certifications with respect to public appearances by third-party research analysts.

Conclusion

All broker-dealers’ policies and procedures governing research analysts and the dissemination of research reports should be modified to comply with the particular requirements of Regulation AC. In particular, foreign broker-dealers that distribute research to United States persons pursuant to Rule 15a-6 should amend their procedures to comply with Regulation AC in all instances except the distribution of research to major U.S. institutional investors through unaffiliated, registered broker-dealers pursuant to Rule 15a-6(a)(2). In all other instances, strict compliance is required.

Please contact the Dorsey & Whitney LLP attorney with whom you work if you have any questions or require any assistance in adapting your company’s compliance policies to the new rules.

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⁵ Third-Party Research Analyst is defined as any research analyst not employed by the broker-dealer or any person associated with the broker-dealer distributing the report. With respect to a covered person, a “third-party research analyst” is defined as any research analyst not employed by the covered person, by the broker-dealer with whom that covered person is associated, or by any other person associated with the broker-dealer.