

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

[Release Nos. 33-8193; 34-47384; File No. S7-30-02]

RIN 3235-A160

Regulation Analyst Certification

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission" "SEC" or "we") is adopting new Regulation Analyst Certification ("Regulation AC"). Regulation AC requires that brokers, dealers, and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views. Broker-dealers would also be required to obtain periodic certifications by research analysts in connection with the analyst's public appearances. By requiring these certifications and disclosures, Regulation AC should promote the integrity of research reports and investor confidence in those reports.

EFFECTIVE DATE: April 14, 2003.

FOR FURTHER INFORMATION CONTACT: James Brigagliano, Thomas Eidt, or Racquel Russell in the Office of Risk Management and Control, Division of Market Regulation, at (202) 942-0772.

SUPPLEMENTARY INFORMATION: We are adopting new Regulation Analyst Certification ¹ under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").

I. Introduction and Summary of Regulation Analyst Certification

During 1999, the Commission and Congress began to closely examine research analysts' conflicts of interest. We were particularly concerned that many investors who rely on analysts' recommendations may not know, among other things, that favorable research coverage could be used to market the investment banking services provided by an analyst's firm, and that an analyst's compensation may be based significantly on generating investment banking business. Moreover, news

reports stated that some analysts had issued reports that did not reflect their true beliefs and communicated to institutional investors views that differed materially from those expressed in their research reports.² Regulation AC, together with other efforts, is intended to address these issues.³

On May 10, 2002, we approved rule changes filed by the NYSE and NASD governing analyst conflicts of interest.⁴ On December 31, 2002, we noticed for comment a second set of proposed rules filed by the NYSE and NASD to further address research analyst conflicts of interest.⁵ These self-regulatory organization rules are part of an ongoing process on our part and that of the NYSE and NASD to address conflicts of interest affecting the integrity and objectivity of research by securities firms. Regulation AC is intended to complement other rules governing conflicts of interest disclosure by research analysts, including NYSE Rule 472, NASD Rule 2711, and the anti-fraud provisions of the federal securities law.

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 ("SOA").⁶ Section 501 of the SOA requires that rules governing analyst conflicts be adopted within a year of enactment, including rules: limiting the supervision and compensatory evaluation of securities analysts; defining periods in which brokers or dealers engaged in a public offering of a security as underwriter or dealer may not publish research on such security; and requiring securities analysts and brokers or dealers to disclose specified conflicts of interest. The Commission voted to propose Regulation AC on July 24, 2002, before the passage of the SOA.⁷ In the

Proposing Release, the Commission noted that it would abide by the directives of the SOA as it continues to address analyst conflicts of interest issues, including with respect to the possible adoption of Regulation AC.

The Commission received twenty-one comment letters in response to the Proposing Release,⁸ which generally supported the proposed regulation. After considering the comments, we are adopting Regulation AC with modifications to the rule to reflect commenters' concerns and to clarify and limit certain provisions. We are also providing interpretive guidance requested by commenters.

A. Certifications in Connection With Research Reports

As adopted, Regulation Analyst Certification requires that brokers, dealers, and their associated persons that are "covered persons"⁹ that publish,¹⁰ circulate, or provide research reports include in those research reports:

(A) A statement by the research analyst (or analysts) certifying that the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and issuers; and

(B) A statement by the research analyst (or analysts) certifying either:

(1) That no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report; or

⁸ See Letters to Jonathan G. Katz, Secretary, Commission, from: The Alliance in Support of Independent Research, dated September 20, 2002 ("Alliance"); Association for Investment Management and Research, dated September 30, 2002 ("AIMR"); The Bond Market Association, dated September 23, 2002 ("TBMA"); Charles Schwab & Co., Inc., dated September 23, 2002 ("Schwab"); Cleary, Gottlieb, Steen & Hamilton, dated September 12, 2002 ("Cleary"); Credit Suisse First Boston, dated September 23, 2002 ("CSFB"); David Norr Inc., dated August 16, 2002 ("David Norr"); Goldman Sachs, dated September 23, 2002 ("Goldman"); Investment Company Institute, dated September 23, 2002 ("ICI"); Investment Counsel Association of America, letters dated September 23, 2002 and January 13, 2003 ("ICAA"); Investorside Research Association, dated September 20, 2002 ("Investorside"); Karr Tuttle Campbell, dated September 27, 2002 ("Karr Tuttle"); Rupert Kenna, dated October 10, 2002; Merrill Lynch, dated September 18, 2002 ("Merrill"); North American Securities Administrators Association, Inc., dated September 23, 2002 ("NASAA"); Salomon Smith Barney, dated September 27, 2002 ("SSB"); Securities Industry Association, dated September 23, 2002 ("SIA"); Sullivan & Cromwell, dated September 23, 2002 ("Sullivan"); Thomson Financial, dated September 23, 2002; and Weiss Ratings, Inc., dated September 10, 2002 ("Weiss").

⁹ "Covered person" is defined in Rule 500 of Regulation AC, and is discussed in detail below at II.A.2.

¹⁰ Publish means to disseminate by any means, including through any third party.

² See, e.g., Gretchen Morgenson, "NASD Sues Star Analyst Over Research," *The New York Times* at A1 (September 24, 2002).

³ On December 20, 2002, the Commission, New York Attorney General, North American Securities Administrators Association, New York Stock Exchange ("NYSE"), National Association of Securities Dealers ("NASD"), and state securities regulators announced an agreement in principle that, if approved by the Commission, would result in a settlement with major investment firms to resolve issues of conflicts of interest relating to the production of research reports. Securities and Exchange Commission Press Release No. 2002-179 (December 20, 2002).

⁴ Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968 (May 16, 2002).

⁵ Securities Exchange Act Release No. 47110 (December 31, 2002), 68 FR 826 (January 7, 2003). The Commission will consider action on these proposed rules after the close of the comment period, which is March 10, 2003.

⁶ Pub. L. 107-204 (2002).

⁷ Securities Exchange Act Release No. 46301 (August 2, 2002), 67 FR 51510 (August 8, 2002) ("Proposing Release").

¹ 17 CFR 242.500 through 505.

(2) That part or all of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. If the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report, the statement must include the source, amount, and purpose of such compensation, and further disclose that it may influence the recommendation in the research report.

All certifications must be clear and prominent.¹¹ If the analyst is unable to certify that the report accurately reflects his or her personal views, distribution of the report by the broker-dealer or covered person would be in violation of Regulation AC. Similarly, if the report does not contain one of the two alternative compensation certifications, distribution of the report by the broker-dealer or covered person would be in violation of Regulation AC.¹²

Research reports generally contain an analyst's summary rating of the security based on his or her particular firm's rating system, as well as an analysis. The summary rating or recommendation is often one word (e.g., buy, sell, overweight), while the analysis may be very detailed and lengthy. Generally, the analysis explains the basis for the rating and provides extensive supplementary information, which, in some instances, significantly qualifies or conditions the stated rating. The Regulation AC certification that the views in the report accurately reflect the analyst's personal views applies to the analysis as reflected in the rating as well as the substance of a research report.

A rating is designed to be a severable summary statement of the analysis in the report. In situations where the analysis significantly qualifies or conditions the stated rating, a communication by the firm or the analyst of only the rating to an investor as representing the analyst's views

about the security could be misleading.¹³ Further, where the analysis contradicts the stated rating, an analyst and the firm could be in violation of the anti-fraud provisions of the federal securities laws. A rating that contradicts the analysis could also render false the analyst's certification, because the analyst's certification reflects both the analysis as well as the rating.

B. Certifications in Connection With Public Appearances

Under Regulation AC, broker-dealers must make and keep records related to public appearances by research analysts. Specifically, if a broker-dealer publishes, circulates, or provides a research report prepared by a research analyst employed by the broker-dealer or a covered person, the broker-dealer is required to make a record within thirty days after each calendar quarter in which the research analyst made any public appearance, that includes:

- 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
- A written statement by the research analyst certifying that no part of such research analyst's compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in any such public appearance.

In cases where the broker-dealer does not obtain a statement by the research analyst in connection with public appearances as described above, the broker-dealer must promptly notify its examining authority, designated pursuant to section 17(d) of the Exchange Act and Rule 17d-2 thereunder, that the analyst did not provide certification in connection with public appearances. In addition, for 120 days following such notification, the broker-dealer must disclose in any research report it distributes authored by that analyst that the analyst did not provide certification specified in Rule 502(a) of Regulation AC. Further, broker-dealers must keep and maintain these records pursuant to Rule 17a-4.

II. Response to Comments on Regulation Analyst Certification

In the Proposing Release, the Commission sought comment on specific aspects of the proposed

regulation, as well as general comments. We received twenty-one comment letters in response to the release. Many commenters expressed support for Regulation AC, although a number also expressed concerns regarding one or more aspects of the proposal, and some suggested alternatives for addressing particular issues. We are adopting Regulation AC with modifications from the proposal that clarify or limit provisions or reflect commenters' views.

A. Defined Terms

We requested comment on whether the proposed definitions of "research report," "research analyst," or "public appearance" should be broader or narrower than proposed. Eleven commenters discussed the scope of the definitions proposed in Regulation AC and noted differences in certain respects compared to definitions contained in the self-regulatory organization ("SRO") rules and the SOA.¹⁴ Generally, commenters believed that compliance efforts would be significantly enhanced by the use of consistent terminology throughout the rules wherever possible.¹⁵ The Commission has conformed the terminology and definitions of Regulation AC to the SRO rules and the SOA wherever appropriate.

1. Definition of "Research Analyst"

Commenters noted that Regulation AC defines "research analyst" more broadly than do the current SRO analyst rules and the SOA. Specifically, the Regulation AC definition as proposed covers "any natural person," rather than only "associated persons of a member" (in the case of the SRO rules) or "associated persons of a registered broker or dealer" (in the case of the SOA). Commenters argued that Regulation AC applies to any person, including employees of investment advisers, foreign entities, or any other third party that prepares a research report that is circulated by a broker-dealer or associated persons.¹⁶

In this regard, Regulation AC is designed to be broader than the SRO rules and the SOA in that it applies to brokers, dealers, and certain associated persons,¹⁷ which may also include investment advisers and others that prepare research reports. We believe that the broad scope of Regulation AC

¹¹ Regulation AC, 17 CFR 242.501(a). The Commission expects that the certifications will be included on the front page of the research report, or that the front page will specify the page or pages on which each certification is found. Disclosures and references to disclosures must be clear and prominent. Electronic research reports may utilize hyperlinks to this disclosure, provided that the first screen that the investor sees clearly and prominently labels the hyperlinks to the required disclosures. When hyperlinks are not possible (such as a report in PDF format), firms should follow the requirements for paper reports. See NYSE Information Memo No. 02-26 (June 26, 2002), and NASD Notice to Members 02-39 (July 2002).

¹² Communications relating to the certifications should be treated as being within the purview of Exchange Act Rule 17a-4(b)(4). See Exchange Act Rule 17a-4(b)(4), 17 CFR 240.17a-4(b)(4).

¹³ Cf. *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969).

¹⁴ See Alliance, AIMR, Cleary, Goldman, ICI, ICAA, SIA, SSB, Schwab, Sullivan, and Thomson Financial.

¹⁵ See, e.g., Cleary and SIA.

¹⁶ See, e.g., Cleary, ICAA, SSB, Sullivan, and Thomson Financial.

¹⁷ See Rule 500 of Regulation AC (definition of "covered person").

is warranted because Regulation AC imposes core standards of integrity that should pertain to all research distributed by broker-dealers and covered persons. On the other hand, we note that Regulation AC is narrower than the SRO rules and the SOA in that its certification requirements apply only to the research analyst or analysts primarily responsible for the content of a research report; junior analysts are not required to certify.¹⁸ This distinction is reasonable because the core integrity standards promoted by Regulation AC are achieved where the analysts primarily responsible for the views expressed in the research report are required to certify. In comparison, the coverage of junior analysts by the SRO rules is appropriate because the concerns those provisions seek to address (for example, trading ahead of research reports) exist with respect to all analysts associated with a member firm and those persons who report to analysts.

2. Definition of "Covered Person"

In response to comments, we have added the definition of "covered person" to narrow the scope of persons to which Regulation AC applies. Covered person means persons associated with a broker or dealer,¹⁹ but not including an associated person that has no officers or employees in common with the broker or dealer and where 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 associated person. In adopting Regulation AC, we have sought to focus the rule on research that appears to be most susceptible to pressures that might compromise its integrity, for example pressures to generate investment banking business.

We believe that it is unnecessary to apply Regulation AC to research published, circulated, or provided by associated persons who have a sufficient

level of independence from the broker or dealer with which they are associated. Associated persons who meet the independence criteria in this definition should have a sufficient level of independence so that pressures from the broker-dealer with which they are associated should not compromise their research. In order to avoid the possibility that an associated person might incorrectly believe that the broker-dealer had policies and procedures to prevent influencing the research of the associated person and, therefore, fail to certify when certification was required, we have added a provision to Regulation AC (Rule 504) that requires a broker or dealer to notify its associated persons that issue research reports as to whether the broker or dealer maintains and enforces such written policies and procedures and whether the associated 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, if so, the identity of those persons.²⁰ We also would not expect that such policies and procedures would interfere with other communications between the associated person and the broker-dealer made in the ordinary course of business and not in violation of any other provision of the securities laws.

We have also excluded from the rule investment advisers that are prohibited under section 203A of the Investment Advisers Act of 1940²¹ ("Advisers Act") from registering with the Commission as investment advisers and not otherwise registered or required to be registered as a broker-dealer. Section 203A was added to the Advisers Act by the National Securities Markets Improvement Act of 1996 ("NSMIA"), which amended the Advisers Act to divide responsibility for regulating investment advisers between the Commission and state securities authorities.²² Section 203A of the

Advisers Act effects this division by generally prohibiting investment advisers from registering with us unless they have at least \$25 million of assets under management or advise a registered investment company.²³ Advisers prohibited from registering with us are subject to the regulation of state securities authorities, but also continue to be subject to the federal securities laws, including the anti-fraud provisions of the federal securities laws.

We also make clear that no provision of the regulation shall 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 Commission as a broker or dealer or investment adviser. Regulation AC was never intended to govern media coverage of issuers.²⁴

3. Definition of "Research Report"

The Commission requested comment on whether the definition of "research report" should be broader or narrower than proposed. Commenters discussed several aspects of the proposed definition, including whether it should cover debt securities, whether it should include electronic communications, and guidance concerning what will and will not be considered a research report.

a. Application to Debt Securities

We specifically requested comment on whether the proposed definition of "research report" should be limited to cover only equity securities. Five commenters discussed the application of Regulation AC to fixed income and all supported the application to debt to some extent.²⁵

The Commission has determined that applying the requirements of Regulation AC to debt securities as well as equity securities would benefit investors because it would provide to debt investors the same benefits as equity

Advisers Act to make them inapplicable to state-registered advisers because "application of these provisions to state-registered advisers is more appropriately a matter for state law." Investment Advisers Act Release No. 1633 (May 15, 1997), 62 FR 28112 (May 22, 1997).

²³ Pursuant to authority under Advisers Act section 203(a)(1)(A) the Commission adopted Advisers Act Rule 203A-1, which made SEC registration optional for certain investment advisers that have between \$25 and \$30 million of assets under management. See Advisers Act Rule 203A-1(a)(1), 17 CFR 275.203A-1(a)(1).

²⁴ It is possible that a broker or dealer or covered person could provide a research report to a media entity intending that it be published. In that case, the report must be certified by the research analyst.

²⁵ See CSFB, Goldman, NASAA, SSB, and TBMA. We note that the SOA and the SRO rules apply only to equity securities.

¹⁸ The proposed definition of "research analyst" referred to any natural person "principally" responsible for research reports; the adopted definition refers to any natural person "primarily" responsible. This modification clarifies that, whether or not a natural person is considered to be principally responsible for research reports as a job description, any natural person who is primarily responsible for the preparation of the content of any research report is a research analyst for the purposes of Regulation AC unless otherwise exempted.

¹⁹ The term "person associated with a broker or dealer" is defined in Exchange Act section 3(a)(18), 15 U.S.C. 78c(a)(18).

²⁰ Associated persons of a member are required under SRO rules to provide prompt notice to his or her employer of employment with any other persons as a result of a business activity. See NASD Rule 3030.

²¹ 15 U.S.C. 80b-3a.

²² Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code). Section 203A was designed to allow the Commission to better use its limited resources by concentrating its regulatory responsibilities on advisers with national businesses, and to reduce the burden to investment advisers of the overlapping and duplicative regulation existing prior to the enactment of NSMIA. See S. Rep. No. 293, 104th Cong., 2d Sess. 2-4 (1996). In conjunction with implementing NSMIA, the Commission amended several "prophylactic" anti-fraud rules under the

investors by promoting the integrity of research reports and confidence in research analyst recommendations.

b. Electronic Communications

Commenters noted that, unlike the SRO rules, the proposed definition of "research report" in Regulation AC did not explicitly include "electronic communications," and requested that the Commission clarify that the regulation would apply to research reports transmitted electronically.

The Commission believes that electronic communications were included under proposed Regulation AC's definition of "research report." However, in response to commenters' concerns, the Commission has modified the proposed definition of "research report" to explicitly include written communications in electronic form.

c. What Constitutes a Research Report?

The Commission has deleted the "recommendation" element from Regulation AC's proposed definition of "research report" to conform to the definition in the SOA. Therefore, "research report" is defined as "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."

Commenters requested that the Commission provide guidance concerning what types of communications the rule is not intended to cover.²⁶ Commenters also requested clarification that Regulation AC would not apply to internal communications.

It is not possible to provide a complete list of all types of communications that would or would not fall within the definition of "research report." Whether a particular communication constitutes a research report for the purposes of Regulation AC will turn on the individual facts and circumstances surrounding that communication. In general, however, the following communications would not be research reports if they do not include an analysis of, or recommend or rate, individual securities or companies:

- 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.

- Reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities.

The following communications would generally not be 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.²⁷
- 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.

4. Definition of "Third Party Research Analyst"

In response to commenters' concerns, we have added a definition of "third party research analyst" in order to refine the scope of Regulation AC. A "third party research analyst" is, with respect to a particular broker or dealer, any research analyst not employed by that broker or dealer or any associated person of that broker or dealer. With respect to a covered person, a "third party research analyst" is any research analyst not employed by that covered person, by the broker or dealer with whom that covered person is associated, or by any other associated person of the broker or dealer with whom that covered person is associated. We believe that research prepared by third party research analysts will not be susceptible to pressures from broker-dealers who distribute their research provided that the analyst's employer meets certain independence criteria.

²⁷ We have focused on a group of fewer than fifteen persons in part because Congress made a determination that an investment adviser who, during the course of the preceding twelve months, has had fewer than fifteen clients and who, among other things, does not hold themselves out generally to the public as an investment adviser, does not have to register with the Commission as an investment adviser. See Advisers Act Rule 203(b)(3), 15 U.S.C. 80b-3(b)(3).

B. Discussion of Certification Requirements

1. Certification by the Primarily Responsible Analyst

Commenters requested clarification on identifying the research analyst that would be required to make the certifications. Commenters argued that multiple certifications would likely be confusing or have other undesirable effects.²⁸

Regulation AC requires that the analyst or analysts primarily responsible for the preparation of the content of a research report comply with the certification requirements. Thus, certification by junior analysts involved in the preparation of a research report is not necessary.²⁹ In some cases, however, there may be more than one research analyst primarily responsible for the content of a research report. In such instances, all analysts who are primarily responsible for the views expressed in the report must provide the certifications. Removing the names of all analysts from a report would not allow the firm to avoid including the required certifications and disclosures; the analyst or analysts primarily responsible for the report must certify.

2. Quantitative and Technical Research

Commenters argued that research based on quantitative and technical models may not be attributed to a particular analyst, may not reflect an analyst's views, and therefore, requested that the Commission provide guidance that these types of research would not be covered.³⁰ One commenter suggested, as an alternative, that Regulation AC should require a certification by the firm that the views expressed in the report are derived from the firm's systematic quantitative research model.³¹

The Commission has determined that, in cases where there is no identified analyst because the report is based on the firm's quantitative or technical model, the firm itself may provide the certifications that the views expressed in the research report accurately reflect the firm's quantitative research model, and that no part of the firm's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views disclosed in the research report.

²⁸ See, e.g., SIA and SSB.

²⁹ The Commission notes that any person not required to comply with the certification requirements of Regulation AC (e.g., junior analysts) would nonetheless be subject to the antifraud provisions of the federal securities laws.

³⁰ See Schwab and SIA.

³¹ See Schwab.

²⁶ See SIA and Schwab.

However, tying an analyst's compensation to the performance of a quantitative or technical model would indicate that the report is the product of the analyst's subjective views (reflected by the design of the model employed). In that case, that analyst must certify the report containing the model's results in accordance with Rule 501 of Regulation AC.

C. Certifications or Disclosures During Public Appearances

We requested comment on what, if any, disclosures should be required during public appearances by analysts. The four commenters that addressed this issue generally were opposed to requiring certifications during analyst public appearances.³² We have determined not to require certifications during public appearances by analysts.

The Commission believes that the proposed quarterly certification requirements in connection with analyst public appearances are sufficient. If the analyst does not provide a certification in connection with public appearances, Rule 502 of Regulation AC requires the broker-dealer to provide readers of research reports that it distributes, as well as the broker-dealer's designated examining authority, with notice that the analyst did not provide the certifications.³³ A Rule 502(b) notice in a research report must be in plain English.

D. Compendium Reports

The Commission requested comment on whether Regulation AC should make allowances for compendium research reports covering six or more securities. Commenters that discussed the treatment of certifications in compendium research reports believed that Regulation AC should permit the required disclosures to appear in a place other than the report itself.³⁴ Most of these commenters specifically supported treatment of compendium reports for the purpose of Regulation AC similar to the treatment allowed under SRO rules. Under SRO rules, members are not obligated to include disclosures in compendiums if the report directs readers to a toll-free number or postal address to write for required disclosures.³⁵ Electronic compendiums may instead include a hyperlink and paper compendiums may also include a web address where disclosures are

located. Two commenters suggested the use of a combined certification that each analyst referenced in the report certifies that the analysis attributed to him or her accurately reflects his or her views.³⁶

The Commission has determined not to permit treatment of compendium research reports in a manner similar to that permitted by the SROs because, unlike the SRO rules, the certifications required by Regulation AC are very concise. Nonetheless, when a research report covers more than one company and each research analyst required to certify with respect to the views expressed in a portion of the report is able to certify that: (a) the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and companies; and (b) that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the research report, the firm may comply with Regulation AC by including one clear and prominent combined certification that, as to each company covered, the respective research analyst (or analysts) certifies as to (a) and (b) above.³⁷

E. Application of Regulation AC to Investment Advisers and Banks

Regulation AC is directed at brokers, dealers, and covered persons, because we believe that these entities are subject to the greatest conflicts. Therefore, investment advisers and banks, among others, may be required to comply with the regulation if they are covered persons of a broker-dealer. The Commission noted in the Proposing Release that the term "research analyst" would not include personnel of an investment adviser, such as a mutual fund portfolio manager, who are not principally responsible for preparing research reports, even if the individuals are registered persons of a broker-dealer (similar to the guidance provided by the SROs in the joint interpretive memorandum).³⁸ The Commission requested comment on whether the regulation should cover banks that are not associated persons and other independent entities, and whether the rule should explicitly exclude investment advisers.

Commenters who addressed the application of Regulation AC to investment advisers generally opposed the rule's coverage of investment advisers and investment advisory personnel.³⁹ Some commenters called for the specific exclusion of investment advisers.⁴⁰ Commenters who addressed the application of Regulation AC to banks generally opposed the rule's coverage of banks.⁴¹ One commenter favored the application of Regulation AC to investment advisers and banks.⁴²

The Commission has determined that Regulation AC should not exclude all investment advisers or banks that are associated with broker-dealers. However, as discussed above, the definition of "covered person" substantially narrows the scope of persons associated with a broker-dealer, such as investment advisers and banks, that are subject to Regulation AC. Where the broker-dealer has informational and structural separations from its associated person, the rule does not apply to that associated person. Where the protections are lacking, however, with respect to a person associated with a broker-dealer, that person is a covered person.⁴³ Accordingly, if an investment adviser or bank is a covered person and publishes, circulates, or provides research reports, the research report certification provisions of Regulation AC will apply. We believe those investment advisers and banks that do not meet the independence criteria that would exclude them from the definition of "covered person" may be subject to greater conflicts than are other investment advisers and banks. Specifically, a broker-dealer's investment banking department could pressure these investment adviser or bank affiliates to comment favorably in a research report or public appearance about a client or prospective client. Moreover, if associated persons that are covered persons were not subject to the certification requirements of Regulation AC, broker-dealers could attempt to funnel research through them to avoid complying with Regulation AC.⁴⁴

³⁹ See Alliance, ICAA, ICI, Investorside, SIA, SSB, Sullivan, and Thomson Financial.

⁴⁰ See, e.g., ICAA and ICI.

⁴¹ See Investorside, SSB, Sullivan, and Thomson Financial.

⁴² See NASAA.

⁴³ As discussed above, Regulation AC requires a broker-dealer to inform its associated persons as to whether or not it maintains and enforces the informational barriers described in Regulation AC.

⁴⁴ Regulation AC is directed at those regulated persons that prepare research reports, as well as persons associated with regulated persons who might be used if attempts were made to improperly circumvent the rule. See also Exchange Act section 20(b), 15 U.S.C. 78t(b).

³² See AIMR, Goldman, SIA, and SSB.

³³ The Commission believes that merely citing to the rule provision would not constitute an adequate notice.

³⁴ See CSFB, Cleary, Goldman, SIA, SSB, and Schwab.

³⁵ See CSFB, Cleary, SIA, SSB, and Schwab.

³⁶ See SIA and SSB.

³⁷ This certification must be in plain English. The Commission would expect that broker-dealers would be able to demonstrate that the combined certification in the report is accurate.

³⁸ See NYSE Information Memo No. 02-26 (June 26, 2002), and NASD Notice to Members 02-39 (July 2002).

F. Application of Regulation AC to Third Party Research

In Proposing Regulation AC, we did not propose to treat research prepared by third parties but distributed by a broker-dealer differently from research produced by the broker-dealer itself. Commenters argued that broker-dealers should not be responsible for certifying research by independent third parties. Moreover, they pointed out practical problems, including the difficulty of tracking analysts employed by third parties.⁴⁵ They also cited increased costs. They argued that firms would discontinue providing the valuable service of making third party research available to customers.⁴⁶

We have determined not to apply Regulation AC where a broker-dealer distributes research prepared by a third party research analyst whose employer satisfies certain independence criteria. The independence criteria require that 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 that the broker-dealer has 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. We believe that research analysts employed by these independent third parties will not be sufficiently susceptible to pressures from distributing broker-dealers to warrant certification. Where a broker-dealer distributes the research of a third party that does not meet the independence criteria, however, the broker-dealer must confirm that the research report includes the same research analyst certification as required by Regulation AC.

Commenters argued that it would be difficult to track analysts employed by third parties, some of whom are overseas, in order to monitor their public appearances and obtain written statements from them. In response to commenters' concerns, we have determined that broker-dealers who distribute third party research are not required to obtain the public appearance certifications required by Rule 502 of Regulation AC with respect to public appearances by third party research analysts.

G. Application of Regulation AC to Foreign Research

In proposing Regulation Analyst Certification, the Commission did not distinguish between research that was issued by a U.S. entity and research that was issued by a non-U.S. entity. Several commenters raised the issue of the Regulation's effect on research originating from a foreign entity. These commenters generally opposed the proposed scope of Regulation AC, which captured foreign entities (and their associated persons) that issue research reports, including those who are not required to be registered with the Commission under section 15 of the Exchange Act.⁴⁷

In light of these comments, we have created a narrow exception for foreign persons that are located outside of the United States and are not associated with a registered broker-dealer that prepares and provides research on foreign securities⁴⁸ to major United States institutions in the U.S. 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, in the case of a research analyst employed outside the United States by a foreign person located outside the United States, Rule 502 of Regulation AC only applies to public appearances while the research analyst is physically present in the United States.

H. Supervision and Oversight

Commenters requested that the Commission clarify that the certification pertaining to the analyst's personal views is not intended to prevent research supervisors or review committees from seeking changes to the research product.⁴⁹ One commenter argued that Regulation AC should not impede the ability of a supervisor or a review committee to require that a report follow a written firm policy on when a research report can upgrade or downgrade a rating, or when it must withhold a rating to prevent conflicts or for other reasons.⁵⁰ Commenters argued that certification also should not preclude the ability of an analyst or a firm to modify the report due to a change in the analyst's opinion or to remove statements that create legal or regulatory concerns.⁵¹

⁴⁷ See, e.g., Cleary and Thomson Financial.

⁴⁸ As defined in the rule, for purposes of Regulation AC, "foreign security" means a security issued by a foreign company for which a U.S. market is not the principal trading market.

⁴⁹ See, e.g., SIA and SSB.

⁵⁰ See SIA.

⁵¹ See SIA and SSB.

The certification required by Rule 501 of Regulation AC does not impede the oversight or review of research reports. If, at the end of the revision process, the analyst still believes that the report accurately reflects his or her personal views about the subject securities or issuers, then that analyst may certify and the firm may use the research report. If, however, after the review process the research report no longer reflects the analyst's personal views, then that analyst would be unable to certify and the firm would not be in compliance with Regulation AC if it uses the research report without a certification.

I. Regulation AC and Fraud Liability Under Federal Securities Laws

Several commenters requested that the Commission reiterate the position stated in the Proposing Release that Regulation AC does not impose new liability on analysts or their firms.⁵² Regulation AC formalizes and potentially adds rigor to analysts' responsibilities to express their views truthfully and without guile.⁵³ Regulation AC makes explicit the representations that are already implicit when an analyst publishes his or her views—that the analysis of a security published by the analyst reflects the analyst's honestly held views.⁵⁴

Regulation AC does not alter any other existing obligation under the federal securities laws for research analysts or broker-dealers.⁵⁵ A research report contains an inherent representation that the views expressed in the report are not knowingly false and do not omit material facts necessary in order to make statements made not misleading.⁵⁶ Thus, even without

⁵² See, e.g., Karr Tuttle, NASAA, SIA, and SSB.

⁵³ As the Commission stated in the Proposing Release, Regulation AC is not intended to create new duties under section 10(b) of the Exchange Act. As a result, no private liability will arise from a broker, dealer, or associated person's failure to make the required disclosure, or make, keep, and maintain required records. However, Regulation AC is subject to the full range of the Commission's enforcement authority. With regard to the enforcement of Regulation AC by the SROs, nothing in Regulation AC is inconsistent with Exchange Act Rule 19g2-1. See 17 CFR 240.19g2-1.

⁵⁴ The use of a certification process echoes and is consistent with one approach employed in the Sarbanes-Oxley Act of 2002, which requires certifications by officers of corporations relating to issuers' financial statements. See Sarbanes-Oxley Act sections 302 and 906, Pub. L. 107-204 (2002).

⁵⁵ See, e.g., Securities Act sections 17(a) and 17(b), 15 U.S.C. 77q; Exchange Act section 10(b), 15 U.S.C. 78j(b), and Rule 10b-5, 17 CFR 240.10b-5.

⁵⁶ See, e.g., Securities Act section 17(a), 15 U.S.C. 77q(a); Exchange Act Rule 10b-5, 17 CFR 240.10b-5; Exchange Act section 15(c)(1)(A), 15 U.S.C. 78o(c)(1)(A); and Exchange Act Rule 15c1-2(b), 17 CFR 240.15c1-2.

⁴⁵ See Alliance and Thomson Financial.

⁴⁶ See, e.g., Schwab.

Regulation AC, analysts may be found to have violated the anti-fraud provisions of the federal securities laws if they make baseless recommendations or recommendations that they disbelieve.⁵⁷

J. Performance-Based Compensation

Commenters expressed concern that Regulation AC could be read to require disclosure of analyst compensation arrangements based on the accuracy or performance of the views expressed as to the subject company's prospects.⁵⁸ Commenters thought that the compensation disclosure provision should be clarified to only require disclosure of compensation that was intended to influence or induce the particular view expressed in the research report.⁵⁹

In the Proposing Release, the Commission noted that Regulation AC does not preclude an analyst from providing otherwise permissible services to his or her firm's investment banking department, and it does not prohibit analysts generally from receiving compensation for covering issuers or for preparing research reports. Instead, Regulation AC focuses on disclosure where the analyst compensation that is related to the specific recommendations or views expressed by the research analyst in the research report. Regulation AC is not intended to address compensation based on the performance of the views expressed regarding the securities discussed.

III. Paperwork Reduction Act

Regulation AC contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").⁶⁰ We have submitted the proposal to the Office of Management and Budget ("OMB") for review in accordance with the PRA.⁶¹ An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number.

In the Proposing Release, the Commission solicited comments on the

collection of information requirements. In response to comments, the Commission has revised the estimates published in the Proposing Release regarding the collection of information burdens associated with the new rule.

A. Summary of Collection of Information

Regulation AC generally requires that research reports published, circulated, or provided by a broker or dealer or covered person contain a statement attesting that the views expressed in each research report accurately reflect the analyst's personal views and whether or not the research analyst received or will receive any compensation in connection with the views or recommendations expressed in the research report. Regulation AC also requires broker-dealers to, on a quarterly basis, make, keep, and maintain records of research analyst statements regarding whether the views expressed in public appearances accurately reflected the analyst's personal views, and whether any part of the analyst's compensation is related to the specific recommendations or views expressed in the public appearance.

B. Reporting and Cost Burden Estimates

Regulation AC provides that brokers, dealers, and covered persons must include in research reports they publish, circulate, or provide certain certifications and disclosures about the analyst's views expressed in the research reports and any relationship between the analyst's compensation and the specific recommendations or views expressed. The regulation also requires broker-dealers to periodically make, keep, and maintain records of research analyst certifications and disclosures in connection with public appearances.

The staff of the Commission believes that the average amount of time it would take to include the required certifications and disclosures in each research report is one minute per report. In the Proposing Release, the Commission staff estimated that broker-dealers publish approximately 657,000 research reports per year. One commenter provided the Commission with data in response to the Proposing Release.⁶² After considering this

additional information, the staff of the Commission believes that broker-dealers publish approximately 1,375,865 research reports per year.⁶³ Therefore, the Commission estimates that the total annual burden in hours for broker-dealers to comply with the research report certification and disclosure requirements is approximately 22,930 hours per year ((1 minute × 1,375,865 reports)/60 minutes).

The Commission staff expects that research analysts will likely be the employees primarily charged with executing certifications and including them in research reports. According to industry sources, research analysts, on average, earn \$189,250 per year, for an hourly pay rate of approximately \$90. Including 35% overhead, Commission staff estimates that the hourly pay rate for a research analyst would be approximately \$121.50. Therefore, the Commission estimates that the total annual burden in dollars for broker-dealers to comply with the research report certification and disclosure requirements is approximately \$2,785,995.00⁶⁴ per year (22,930 hours × \$121.50 per hour).

Rule 501 of Regulation AC, which applies to research reports, may also impose requirements on certain entities if they are associated with a broker-dealer and meet the definition of "covered person." However, "covered persons" are not subject to Rule 502 of Regulation AC, which addresses public appearances. The Commission estimates that approximately 2,650 SEC registered investment advisers are associated with a broker-dealer. We believe that not all of these entities write research reports, and that those who do write research reports write relatively few. Of those investment advisers that are associated with a broker-dealer and that write research reports, we do not believe that all of them will meet the definition of a "covered person," as defined by

through First Call Research Direct. Thomson Financial asserted that, when these additional sell-side reports are accounted for, the total exceeds 2 million reports a year. Thomson Financial suggested that the compliance costs for sell-side firms could run as high as \$4,116,784.50.

⁶³ After further consultation with Thomson Financial, they have revised their total estimated number of research reports per year for 2001 to range between 1,375,865 and 1,540,150. The staff believes that the overall calculations are over-inclusive and possibly duplicative. As a result, we are basing our estimates on the lower-end of the range of the number of research reports per year. The staff believes that this estimate continues to be conservative.

⁶⁴ The estimated total annual burden in dollars for broker-dealers to comply with the research report certification and disclosure requirements would be approximately \$3,118,642.00 if calculated using the high-end of the estimated range for the number of research reports.

⁵⁷ See Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968, 34977 (May 16, 2002); Proposing Release at 51512; *Cf. Hanly*, supra, note 13, at 597. See also *In the Matter of Robertson Stephens, Inc.*, Administrative Proceeding File No. 3-11003 (January 9, 2003) (settled fraud action against broker-dealer where Commission found that a research analyst employed by the broker-dealer issued recommendations about a public company that were inconsistent with his privately communicated beliefs about the company.)

⁵⁸ See, e.g., Goldman and Merrill.

⁵⁹ See, e.g., Cleary, SIA, SSB, and Sullivan.

⁶⁰ 44 U.S.C. section 3501 *et seq.*

⁶¹ 44 U.S.C. section 3507(d) and 5 CFR 1320.11.

⁶² Thomson Financial asserted in its comment letter that the Commission's cost estimate in the Proposing Release was too low. Thomson Financial noted that the Commission cited data from Thomson Financial First Call and estimated that broker-dealers publish 657,000 research reports per year. Thomson Financial asserted that, while this estimate may accurately reflect equity research on U.S. securities transmitted via First Call Notes, it did not capture fixed-income research, research on non-U.S. equities or full-text reports transmitted

Regulation AC. As a conservative estimate, however, if all SEC registered investment advisers are covered persons and on average publish as many research reports per year as the average broker-dealer (250 research reports), the estimated total number of research reports published by SEC registered investment advisers who are associated with a broker-dealer would be approximately 662,500 ($250 \times 2,650$).⁶⁵ Therefore, the Commission estimates that the total annual analyst certification burden in hours for these investment advisers would be 11,040 hours ($(1 \text{ minute} \times 662,500 \text{ research reports}) / 60 \text{ minutes}$). The Commission estimates that the annual burden in dollars of complying with the research report certification and disclosure requirements for SEC registered investment advisers is approximately \$1,341,360 per year⁶⁶ ($11,040 \times \121.50). Unlike Rule 501, Rule 502 of Regulation AC (public appearances) does not apply to covered persons. We note, however, that we believe that a significant number of associated persons would not be "covered person(s)," as defined in Rule 500 of Regulation AC and, as a result, the aggregate burden for persons associated with broker-dealers to comply with the research report certification and disclosure requirements will be significantly lower.

The staff of the Commission believes that the research analyst will prepare the quarterly statement required for public appearances. The staff estimates that the average amount of time it would take a research analyst to prepare the quarterly statements regarding public appearances as required by the regulation is ten minutes per analyst. The staff of the Commission believes that, on average, approximately 519 public appearances by research analysts occur per quarter,⁶⁷ or about 2,076 per year. Therefore, the Commission believes that the total annual burden for broker-dealers in hours of complying

with the public appearance certification and disclosure requirements would be approximately 346 hours per year ($(10 \text{ minutes} \times 2076 \text{ appearances}) / 60 \text{ minutes}$).

In cases where the broker or dealer does not obtain a statement by the research analyst in connection with public appearances as described above, the broker-dealer must promptly notify its examining authority, designated pursuant to section 17(d) of the Exchange Act and Rule 17d-2 thereunder, that the analyst did not provide certification in connection with public appearances. In addition, for 120 days following such notification, the broker-dealer must disclose in any research report it distributes authored by that analyst that the analyst did not provide certification specified in Rule 502(a) of Regulation AC. Further, broker-dealers must keep and maintain these records pursuant to Rule 17a-4(b)(4). Broker-dealers are also expected to have records that document the process they followed in producing each research analyst certification. The staff of the Commission believes that there will be few, if any, instances where a broker-dealer will provide notification to their examining authority, as analysts and their firms will have strong incentives to avoid having to make the type of disclosures required to be provided to their examining authority. Therefore, the total annual burden, in dollars, of complying with the public appearance certification requirements would be approximately \$42,039 ($346 \text{ hours} \times \121.50).

The regulation requires that the records of statements regarding public appearances be preserved in accordance with Exchange Act Rule 17a-4(b)(4). Exchange Act Rule 17a-4(b)(4) requires that any communication relating to a broker-dealer's business, including inter-office communications, must be kept for at least three years. In light of the existing record preservation requirement for brokers and dealers under Exchange Act Rule 17a-4(b)(4),⁶⁸ the staff of the Commission believes that any additional costs to preserve the records of the certifications required by the regulation would be minimal.

Rule 500 of Regulation AC includes a definition of "covered person," which limits the scope of the regulation's application. Rule 504 of Regulation AC requires a broker-dealer to notify its associated persons that issue research reports as to whether associated persons would meet the definition of "covered persons" under Regulation AC, and, therefore, be subject to the rule.

Specifically, the broker-dealer must inform its associated persons whether 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 associated persons. Broker-dealers must also inform its associated persons whether associated persons have any officers or employees in common with the broker or dealer who can influence the activities of research analysts or the content of research reports and, if so, the identity of those persons.

The staff has not obtained data on the amount of time it would take for broker-dealers to make the necessary determinations and to draft and provide the notification required under Rule 504 of Regulation AC. For PRA purposes, the below calculations represent the staff's estimates of the amount of time that would be required for broker-dealers to comply with Rule 504. The staff estimates that there are approximately 2,650 investment advisers that are associated with at least one broker-dealer. The staff estimates that it would take approximately one hour per year for each of the approximately 2,650 broker-dealers to determine whether it 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 associated persons. The staff estimates that it would take approximately thirty minutes per year for each broker-dealer to determine whether its associated persons have any officers or employees in common with the broker or dealer who can influence the activities of research analysts or the content of research reports and, if so, the identity of those persons.⁶⁹

The staff estimates that it would take fifteen minutes per year for each broker-dealer to draft and provide the required notification to its associated persons. The Commission staff expects that a compliance officer will likely be the employee primarily charged with making the necessary determinations, and drafting and providing the required notification. According to industry sources, in 2002, compliance officers,

⁶⁹ Broker-dealers should already have mechanisms in place to determine whether such persons exist and, if so, the identity of those persons because of NASD Rule 3030. See NASD Rule 3030.

⁶⁵ We believe that including all SEC registered investment advisers in calculating the paperwork burden as to covered persons is over-inclusive as to investment advisers, and that this estimate is therefore sufficient to account for other types of entities who would meet the definition of "covered person."

⁶⁶ The estimated total annual burden in dollars for SEC registered investment advisers to comply with the research report certification and disclosure requirements would be approximately \$1,501,518.00 if calculated using the high-end of the estimated range for the number of research reports.

⁶⁷ 519 is approximately 10% of the estimated 5,186 research analysts employed in the U.S., which is based on information provided by Nelson Information. One commenter believes that this estimate is low, but did not provide specific data in support of its views. See Thomson Financial.

⁶⁸ OMB Control No. 3235-0279.

on average, earned approximately \$82.00/per hour. Including 35% overhead, Commission staff estimates that the hourly pay rate for a compliance officer would be \$110.70 per hour. Therefore, the Commission estimates that the annual burden for broker-dealers in hours of complying with the notification requirements would be approximately 4,638 hours ($[2,650 \times 105 \text{ minutes}]/60$). The staff estimates that the annual burden for broker-dealers of complying with the notification requirements in dollars would be approximately \$513,427.00 ($4,638 \text{ hours} \times \110.70).

Therefore, the Commission estimates that the regulation would result in a total annual burden in hours of approximately 38,954 hours (22,930 hours for broker-dealers to comply with the research report requirements + 11,040 hours for investment advisers to comply with the research report requirements + 346 hours for broker-dealers to comply with the public appearance requirements + 4,638 hours for broker-dealers to comply with the notification requirements), for a total annual cost in dollars of approximately \$4,682,821 (\$2,785,995 for broker-dealers to comply with the research report requirements + \$1,341,360 for investment advisers to comply with research the report requirements + \$42,039 for broker-dealers to comply with the public appearance requirements + \$513,427 for broker-dealers to comply with the notification requirements).

IV. Costs and Benefits of Adopted Regulation Analyst Certification

To assist the Commission in evaluating the costs and benefits that may result from adopting Regulation AC, the Commission sought comment on any potential costs, as well as any potential benefits, resulting from the proposal for investors, issuers, broker-dealers, other securities industry professionals, SROs, or others. The Commission also requested that commenters provide analysis and data to support their views. Regulation AC is part of an ongoing process by the Commission to address conflicts of interest affecting the production and dissemination of research by securities firms, and to provide increased disclosure to investors. Regulation AC includes a requirement that broker-dealers and covered persons include in research reports they publish certain certifications and disclosures about the analyst's views expressed in the research reports and any relationship between the analyst's compensation and the specific recommendations or views

expressed. Regulation AC would also require broker-dealers to make, keep, and maintain records of research analyst certifications and disclosures in connection with public appearances. We are sensitive to the costs and benefits that result from our rules. The Commission initially identified certain costs and benefits relating to the proposals and encouraged commenters to discuss any additional costs or benefits. We discuss these costs and benefits below.

A. Costs

The Commission received letters from twenty-one commenters concerning Regulation AC. Only one commenter provided actual data to quantify the costs identified. This commenter believed that the estimates set forth in the proposing release were low primarily because the estimated number of research reports per year did not capture, among other things, reports by investment advisers and certain full-text reports.⁷⁰ The Commission modified its estimates in response to these comments.

The Commission also requested comment on how many public appearance certifications would likely be submitted to brokerage firms per quarter, and how many of those statements would be required to be provided to the firm's examining authority. One commenter believed that the estimate of the number of public appearances was too low, but did not provide specific data in support of its views.⁷¹

While Regulation AC may lead to some additional costs for brokers, dealers, and covered persons, we continue to believe that any costs should not be significant. In light of current requirements for broker-dealers under SRO rules, the Commission estimates that, beyond the paperwork costs described above, any additional costs to broker-dealers that would result from the required certifications and disclosures would be minimal. In the Proposing Release, the staff estimated that broker-dealers publish approximately 657,000 research reports per year. One commenter provided information that suggests that broker-dealers publish as many as 1,375,865 research reports per year.⁷² Given the refined scope of Regulation AC, the staff believes that these two estimates represent a reasonable range with which to estimate research reports affected by

the rule. Accordingly, the Commission estimates the total direct costs to be approximately \$2.5 million to \$4.7 million.⁷³ In addition, because the rule is minimally burdensome, the Commission believes that, beyond the paperwork costs described above, any additional costs to associated persons that would result from certifications and disclosures would be minimal.

Moreover, with respect to the compensation certifications and disclosures that are required by Regulation AC, broker-dealers are already required to make certain disclosures regarding research analyst compensation under SRO rules. For example, SRO rules currently require that firms disclose in research reports if the associated person preparing the report received compensation that is based upon (among other factors) the member's overall investment banking revenues.⁷⁴ Further, SRO rules prohibit members from offering favorable research to a company as consideration or inducement for the receipt of business or for compensation.⁷⁵ Additionally, Exchange Act Rule 17a-3(a)(19) currently requires broker-dealers to maintain a record of all agreements pertaining to the relationship between each associated person and the broker-dealer, including a summary of each associated person's compensation arrangement or plan.

In response to commenters' concerns, we modified the proposed rule text to include a definition of "covered person," which limits the scope of the regulation's application. Rule 504 of Regulation AC requires broker-dealers to notify its associated persons that issue research reports as to whether the broker-dealer maintains and enforces written policies and procedures reasonably designed to prevent the broker or dealer or any of its controlling

⁷³ The total burden range of approximately \$2.5 million to \$4.7 million is obtained by applying both the low and the high research report estimates. Costs are proportionate to the number of research reports assumed to be issued each year. For purposes of the Paperwork Reduction Act analysis, we used the estimate of 1,375,865 research reports to obtain the high end of the burden range. If we instead substitute the low estimate of 657,000 research reports in place of the high estimate, the low end of the burden range is approximately \$2.5 million. The low research report estimate is approximately 48% of the high estimate and the resulting total annual cost burden is approximately \$2.5 million (\$1,337,278 for broker-dealers to comply with the research report requirements + \$643,853 for investment advisers to comply with the research report requirements + \$42,039 for broker-dealers to comply with the public appearance requirements + \$513,427 for broker-dealers to comply with the notification requirements = \$2,536,596).

⁷⁴ NASD 2711(h)(2)(A)(i); NYSE 472(k)(2).

⁷⁵ NASD Rule 2711(e); NYSE Rule 472(g).

⁷⁰ See Thomson Financial.

⁷¹ *Id.*

⁷² See Thomson Financial and footnote 63 for a discussion of revisions to the original estimate.

persons, officers, or employees from influencing the activities of research analysts and the content of research reports prepared by the associated person, and to inform associated persons as to whether the associated 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, if so, the identity of those persons. Broker-dealers may incur costs in providing this notification to each of its associated persons. As noted previously, the staff estimates that the paperwork costs for broker-dealers of complying with the notification requirements in dollars would be approximately \$513,427.00. Any additional costs should not be significant in part because associated persons of an SRO member are required under SRO rules to provide prompt notice to his or her employer of employment with any other persons as a result of a business activity.⁷⁶

With respect to public appearances, current SRO rules require analysts to make certain disclosures during public appearances, such as the member's or the analyst's ownership interests in the subject company. SRO rules also require analysts to disclose any other actual, material conflict of interest of which the research analyst knows, or has reason to know, at the time of the public appearance.⁷⁷

Broker-dealers should already have in place procedures necessary to comply with many components of Regulation AC due to existing obligations under SRO rules, although these procedures might require some minor modifications to conform with Regulation AC. As noted previously, the Commission estimates that the annual paperwork costs in dollars of complying with the regulation would be approximately \$4,682,821.

B. Benefits

We believe that investor confidence in the integrity of research has suffered because there is evidence that, in some cases, research analyst objectivity has been compromised due to, among other things, analysts' personal compensation and firms' investment banking relationships with issuers that are the subjects of research reports. Requiring research analysts to certify that the views expressed in research reports reflect their personal views, and requiring disclosure of information regarding whether analyst compensation

is related to the specific recommendations made, should help bolster investor confidence in the quality of research. This, in turn, should help increase investor confidence in the securities markets.

The Commission requested comment on whether the certification and disclosure requirements, if adopted, would promote investor confidence in the views expressed by research analysts and provide investors with useful information with which to evaluate potential biases. Ten commenters expressed support for Regulation AC. Generally, these commenters were of the view that Regulation AC would promote the integrity of research and investor confidence.⁷⁸ Three commenters did not agree that Regulation AC would advance investor protection and/or investor confidence to any significant degree.⁷⁹

Regulation AC requires that broker-dealers and covered persons include certifications in research reports regarding the truthfulness of the views expressed in research reports and whether or not the analyst received compensation in connection with his or her specific recommendations or views. Many investors rely on the research reports and recommendations provided by their brokers and covered persons. To the extent that the Regulation AC requires disclosures that provide more transparency than provided by current regulation, these disclosures should provide investors with important information with which to determine the value of the research available to them.⁸⁰

Regulation AC may result in an increase in the overall quality of the research available to the public because broker-dealers and covered persons would be in violation of Regulation AC when issuing research reports unless the reports include the required certifications and disclosures. The requirement that the research analyst (or analysts) primarily responsible for preparing the research report personally certify that the views expressed in the report accurately reflect his or her personal views creates an incentive for analysts to examine, even more carefully, the basis and foundations for his or her recommendations in preparing research reports.

Regulation AC may also result in an increase in the quality of research because of competitive reasons. Firms

that publish research reports that do not contain certain analyst certifications will be in violation of the regulation, and firms whose research analysts' compensation is related to the specific recommendations or views provided in research reports (to the extent allowed by SRO rules) may lose some business to firms that are less conflicted. Regulation AC is intended to enhance investor confidence in the integrity of the research available to them. We believe that by requiring research analysts to certify as to the truthfulness of the views expressed in research reports, investor confidence in the securities markets should be enhanced, thereby leading to the benefit of more liquid and efficient markets. The Commission does not have data to quantify the value of the benefits described above. The Commission requested, but did not receive, comment on how it may quantify these benefits. The Commission also requested, but did not receive, comment concerning any benefits, not already identified, that may result from the adoption of Regulation AC.

V. Regulatory Flexibility Act Certification

Pursuant to section 605(b) of the Regulatory Flexibility Act,⁸¹ the Commission certified that Regulation AC will not have a significant economic impact on a substantial number of small entities. This certification, including the reasons supporting the certification, were set forth in the Proposing Release.

The Commission solicited comments on the potential impact of Regulation AC on small entities in the Proposal. No comments were received that discussed the Regulatory Flexibility Act Certification. However, in response to other comments, the Commission has revised its estimates and believes that the total burden in hours required to comply with proposed Regulation AC would be approximately 5.78 hours per year, per small firm, as compared to the original estimate of two hours and two minutes per year, per small firm.

VI. Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act⁸² requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition,

⁷⁸ See AIMR, CSFB, Goldman, ICAA, ICI, Merrill, SIA, SSB, Schwab, and TBMA.

⁷⁹ See David Norr, NASAA, and Thomson Financial.

⁸⁰ See Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968 (May 16, 2002).

⁸¹ 5 U.S.C. 605(b).

⁸² 15 U.S.C. section 78c(f).

⁷⁶ See NASD Rule 3030.

⁷⁷ NASD Rule 2711(h); NYSE 472(k)(1).

and capital formation. In addition, section 23(a)(2)⁸³ of the Exchange Act requires the Commission to consider the impact any rule would have on competition. Further, the law requires that the Commission not adopt any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

In the Proposing Release, the Commission solicited comment on the proposal's effect on competition, efficiency, and capital formation. Three commenters believed that Regulation AC would impose an inappropriate burden on competition.⁸⁴ One commenter asserted that the scope of Regulation AC was overly broad and would apply unnecessarily to, and be an onerous burden on, broker-dealer firms that are not subject to the conflicts the regulation is designed to address.⁸⁵ Another commenter asserted that Regulation AC may serve as a barrier to entry and an impediment to competition for firms seeking to provide an alternative to sell-side research.⁸⁶

Regulation AC is intended to enhance investor confidence in the integrity of the research available to them. Further, we have modified the rule from the proposal and have limited the scope of its application. We believe that requiring broker-dealers and covered persons to include analyst certifications in research reports, as well as the other disclosures required by Regulation AC, should enhance investor confidence in the securities markets, thereby leading to a more efficient market.

The Commission has considered Regulation AC in light of the standards in section 23(a)(2) and believes that it would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. As discussed above in the Cost-Benefit section, the Commission recognizes that Regulation AC may lead to some additional costs for broker-dealers and covered persons. On balance, we think that the application of Regulation AC is tailored to those situations where the conflicts are most likely to affect research. As such, we do not believe that the rule would create an unreasonable burden on competition. Further, we believe that providing the benefits that will result from the rule in those conflict-laden situations will further the purposes of the rule,

including enhancing investor confidence in the market, thereby leading to a more efficient market.

VII. Statutory Authority

Regulation AC is being adopted pursuant to sections 3, 15, 17, and 23 of the Exchange Act and pursuant to sections 17 and 19 of the Securities Act.

Text of the Rule

List of Subjects in 17 CFR Part 242

Brokers, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is amended as follows.

PART 242—REGULATIONS M, ATS, AND AC AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for part 242 continues to be read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 80a-23, 80a-29, and 80a-37.

2. The part heading for part 242 is revised as set forth above.

3. Part 242 is amended by adding Regulation AC, §§ 242.500 through 242.505 to read as follows:

Sec.

242.500 Definitions.

242.501 Certifications in connection with research reports.

242.502 Certifications in connection with public appearances.

242.503 Certain foreign research reports.

242.504 Notification to associated persons.

242.505 Exclusion for news media.

Regulation AC—Analyst Certification

§ 242.500 Definitions.

For purposes of Regulation AC (§§ 242.500 through 242.505 of this chapter) the term:

Covered person of a broker or dealer means an associated person of that broker or dealer but does not include:

(1) An associated person:

(i) If the associated person has no 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

(ii) If the broker or dealer maintains and enforces written policies and procedures reasonably designed to prevent the broker or dealer, any controlling persons, officers (or persons performing similar functions), and employees of the broker or dealer from

influencing the activities of research analysts and the content of research reports prepared by the associated person.

(2) An associated person who is an investment adviser:

(i) Not registered with the Commission as an investment adviser because of the prohibition of section 203A of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3a); and

(ii) Not registered or required to be registered with the Commission as a broker or dealer.

Note to definition of covered person: An associated person of a broker or dealer who is not a covered person continues to be subject to the federal securities laws, including the anti-fraud provisions of the federal securities laws.

Foreign person means any person who is not a U.S. person.

Foreign security means a security issued by a foreign issuer for which a U.S. market is not the principal trading market.

Public appearance means 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.

Registered broker or dealer means a broker or dealer registered or required to register pursuant to section 15 or section 15B of the Securities Exchange Act of 1934 (15 U.S.C. 78o or 78o-4) or a government securities broker or government securities dealer registered or required to register pursuant to section 15C(a)(1)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5(a)(1)(A)).

Research analyst means any natural person who is primarily responsible for the preparation of the content of a research report.

Research report means 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.

Third party research analyst means:

(1) With respect to a broker or dealer, any research analyst not employed by that broker or dealer or any associated person of that broker or dealer; and

(2) With respect to a covered person of a broker or dealer, any research analyst not employed by that covered person, by the broker or dealer with whom that covered person is associated,

⁸³ 15 U.S.C. section 78w(a)(2).

⁸⁴ See Alliance, Investorside, and Thomson Financial.

⁸⁵ See Alliance.

⁸⁶ See Investorside.

or by any other associated person of the broker or dealer with whom that covered person is associated.

United States has the meaning contained in § 230.902(l) of this chapter.

U.S. person has the meaning contained in § 230.902(k) of this chapter.

§ 242.501 Certifications in connection with research reports.

(a) A broker or 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 shall include in that research report a clear and prominent certification by the research analyst containing the following:

(1) A statement attesting that all of the views expressed in the research report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers; and

(2)(i) A statement attesting that no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report; or

(ii) A statement:

(A) Attesting that part or all of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report;

(B) Identifying the source, amount, and purpose of such compensation; and

(C) Further disclosing that the compensation could influence the recommendations or views expressed in the research report.

(b) A broker or dealer or covered person that publishes, circulates, or provides a research report prepared by a third party research analyst to a U.S. person in the United States shall be exempt from the requirements of this section with respect to such research report if the following conditions are satisfied:

(1) The employer of the third party research analyst has no officers (or persons performing similar functions) or employees in common with the broker or dealer or covered person; and

(2) The broker or dealer (or, with respect to a covered person, the broker or dealer with whom the covered person is associated) maintains and enforces written policies and procedures reasonably designed to prevent the

broker or dealer, any controlling persons, officers (or persons performing similar functions), and employees of the broker or dealer from influencing the activities of the third party research analyst and the content of research reports prepared by the third party research analyst.

§ 242.502 Certifications in connection with public appearances.

(a) If a broker or dealer publishes, circulates, or provides a research report prepared by a research analyst employed by the broker or dealer or covered person to a U.S. person in the United States, the broker or dealer must make a record within 30 days after any calendar quarter in which the research analyst made a public appearance that contains the following:

(1) 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

(2) A statement by the research analyst attesting that no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in such public appearances.

(b) If the broker or dealer does not obtain a statement by the research analyst in accordance with paragraph (a) of this section:

(1) The broker or dealer shall promptly notify in writing its examining authority, designated pursuant to section 17(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(d)) and § 240.17d-2 of this chapter, that the research analyst did not provide the certifications specified in paragraph (a) of this section; and

(2) For 120 days following notification pursuant to paragraph (b)(1) of this section, the broker or dealer shall disclose in any research report prepared by the research analyst and published, circulated, or provided to a U.S. person in the United States that the research analyst did not provide the certifications specified in paragraph (a) of this section.

(c) In the case of a research analyst who is employed outside the United States by a foreign person located outside the United States, this section shall only apply to a public appearance

while the research analyst is physically present in the United States.

(d) A broker or dealer shall preserve the records specified in paragraphs (a) and (b) of this section in accordance with § 240.17a-4 of this chapter and for a period of not less than 3 years, the first 2 years in an accessible place.

§ 242.503 Certain foreign research reports.

A foreign person, located outside 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 U.S. person in the United States in accordance with the provisions of § 240.15a-6(a)(2) of this chapter shall be exempt from the requirements of this regulation.

§ 242.504 Notification to associated persons.

A broker or dealer shall notify any person with whom that broker or dealer is associated who publishes, circulates, or provides research reports:

(a) Whether the broker or dealer maintains and enforces written policies and procedures reasonably designed to prevent the broker or dealer, any controlling persons, officers (or persons performing similar functions), or employees of the broker or dealer from influencing the activities of research analysts and the content of research reports prepared by the associated person; and

(b) Whether the associated 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, if so, the identity of those persons.

§ 242.505 Exclusion for news media.

No provision of this Regulation AC shall apply to any person who:

(a) Is the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; and

(b) Is not registered or required to be registered with the Commission as a broker or dealer or investment adviser.

Dated: February 20, 2003.

By the Commission.

Margaret H. McFarland,
Deputy Secretary.

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