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# Advisory

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## SECURITIES LAW

### SEC Proposes "Regulation Analyst Certification" to Address Research Analyst Conflicts of Interest

In our June 19, 2002 Advisory, "SEC Approves New Rules Addressing Research Analyst Conflicts of Interest,"<sup>1</sup> we reported that the Securities and Exchange Commission (SEC) had approved rules proposed by the National Association of Securities Dealers, Inc. (NASD) and the New York Stock Exchange (NYSE), which are designed to provide full disclosure on potential conflicts of interest involving research analysts. The NASD and NYSE rules call for greater independence of research analysts from their firms' investment banking departments and full disclosure of any compensation received by the firms from the companies that are covered by the analysts. On August 2, 2002, the SEC published for public comment its own proposed rule regarding research analyst conflicts of interest, entitled "Regulation Analyst Certification" or "Regulation AC," which is intended to supplement the NASD and NYSE rules and to provide the public with additional assurance about the integrity and impartiality of research reports.

#### NASD and NYSE Rules on Research Analyst Conflicts of Interest

Under new NASD Rule 2711 and amended NYSE Rule 472:

- compensation of research analysts cannot be tied to specific investment banking services;
- firms cannot offer favorable research ratings to obtain investment banking services;
- research analysts are subject to trading blackout windows around the publication of their research reports and are prohibited from trading against their recommendations (*i.e.*, selling or buying shares of a company for which they have issued a public recommendation to "hold" such shares);
- firms must disclose in research reports the amount of compensation they have received from providing investment banking services to covered companies during the previous twelve months, and whether such firms intend to receive compensation from covered companies in the three months following publication of a research report;
- a firm's investment banking department may not comment on a research analyst's research report except to verify factual accuracy through the firm's legal or compliance department;
- covered companies likewise are limited to verifying the factual accuracy of research reports through their legal departments and may not preview recommendations; and
- firms must provide information in research reports on the breakdown of recommendations assigned to "buy," "hold/neutral" and "sell" categories and the percentage of their investment banking services for clients in each category for the previous twelve months.

## Regulation Analyst Certification

Regulation AC, as proposed by the SEC, would require that research analysts make certifications in their research reports regarding the views expressed in those reports, and would require firms to keep quarterly certifications from their research analysts regarding the impartiality of recommendations that were made by the analysts in public appearances.

## Certifications Required from Research Analysts in Research Reports

Regulation AC would require that a research report<sup>2</sup> include a clear and prominent certification by the research analyst<sup>3</sup> that:

- the views expressed in the research report accurately reflect the research analyst's personal views about any and all of the securities or issuers covered in the report, and
- 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.

If the analyst is unable to make the certification regarding compensation because his or her compensation is related in some way to the recommendations or views set forth in the report, the certification must identify the source, amount and purpose of the compensation, and must state that the compensation could influence the recommendations or views expressed in the research report. Regulation AC provides no exception to the certification requirement regarding the accuracy of reflection of the analyst's personal views.

<sup>2</sup> A research report is defined in Regulation AC as a written communication that includes an analysis of the securities of an issuer or issuers, provides information reasonably sufficient upon which to base an investment decision, and includes a recommendation.

<sup>3</sup> A research analyst is defined in Regulation AC as any natural person who is principally responsible for the analysis of any security or issuer included in a research report.

## Certifications Required from Firms and Research Analysts Regarding Public Appearances

Firms employing research analysts must adhere to a separate certification requirement. Within thirty days after the end of a calendar quarter in which a research analyst has made a public appearance, the firm that employs the analyst must obtain a certification from the analyst that:

- the views expressed in each public appearance accurately reflected the research analyst's personal views at that time about the subject securities and issuers, and
- 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 any public appearance.

For purposes of this certification, "public appearance" includes participation in any seminar, forum (including any electronic interactive forum), radio or TV interview, or any other public speaking activity in which the analyst offers an opinion or specific recommendation concerning a security or an issuer. Firms employing research analysts would be required to provide these certifications to their examining authorities.

If a research analyst is unable to provide the proposed certifications described above regarding public appearances, he or she would have to provide an explanation for such failure to the firm, and the firm would be obligated to keep a record of that explanation. The failure to provide the certification would have to be noted and explained in all reports prepared by the research analyst for the next 120 days from the date on which the certification was due and not provided.

## Additional Notes

The SEC notes that Regulation AC would not impose new liability on research analysts, because analysts may already be found to have violated the anti-fraud provisions of the securities laws if they make recommendations that have no basis in fact. The SEC also notes

that no private right of action would arise under Regulation AC from the failure of a broker, dealer or associated person to make the required disclosure or to keep the required records.

In addition, as proposed, Regulation AC would apply to reports issued and statements made by research analysts with respect to both debt securities and equity securities. Currently, the rules of the NASD and NYSE relating to research analyst conflicts of interest apply only to equity securities.

## Impact of the Sarbanes-Oxley Act on Research Analysts

In Section 501 of the Sarbanes-Oxley Act of 2002, Congress directed the SEC, or, upon the SEC's direction, a self-regulatory organization, to adopt, by July 30, 2003, rules designed to address conflicts of interest involving the research analyst community. The topics which the SEC was directed to address by Section 501 substantially overlap with the rules recently adopted or amended by the NYSE and NASD, as described above. The primary area addressed in Section 501 that was not covered in the NYSE and NASD rules is an express prohibition on retaliation by firms against their research analysts who issue negative research reports on clients of the firms, even if the negative report adversely affects an investment banking relationship between the firm and the subject company.

We expect that the SEC will fulfill the directive of Section 501 by harmonizing any remaining areas of difference between the provisions of Section 501 and the NYSE and NASD rules in the final rules to be issued in response to Section 501.

## What to Expect Next

The SEC is seeking public comment on Regulation AC until September 23, 2002. We will apprise you of any final rules in a future Advisory.

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*Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions on this information.*