

holder nomination procedure is premised upon the existence of a state law right of security holders to nominate candidates for election as directors.¹⁶² As we have previously stated, the exemptive rule provision requiring independent directors to select and nominate any other independent director was not intended to supplant or limit the ability of fund security holders under state law to nominate independent directors.¹⁶³

b. Questions

L.1. Should the proposed security holder nomination procedure apply to funds? If so, to which funds should it apply? Are there any aspects of the proposed nomination procedure that should be modified in the case of funds?

L.2. Should we apply the "interested person" standard of Section 2(a)(19) of the Investment Company Act with respect to the representation that a security holder nominee be independent from a company that is a fund? Should the "interested person" standard also apply to security holder nominees for election to the board of directors of a business development company? Should we instead apply a different independence standard to funds or business development companies, such as the definition of independence in Exchange Act Rule 10A-3?¹⁶⁴

L.3. Is it appropriate to require a nominating security holder or group of security holders of a mutual fund to provide disclosure of its 5% beneficial ownership of the fund's securities in its notice to the fund of its intent to require its nominee on the fund's proxy card? If so, what requirements from Exchange Act Schedule 13G (or other information) should be required to be included in the notice? Should such a security holder or group instead be required to file on Exchange Act Schedule 13G upon reaching the 5% beneficial ownership threshold, in order to provide the fund with notice in advance that the security holder or group has reached this threshold? If so, are there any requirements of Exchange Act Schedule 13G that should be modified for this purpose?

L.4. Are the triggering events proposed for use of the security holder nomination procedure appropriate for funds? Are there other nomination procedure triggering events that should be used?

L.5. Should a fund be required to provide disclosure on Form N-CSR of

whether it would be subject to the security holder nomination procedure as a result of a security holder vote with regard to any of the nomination procedure triggering events, and the required disclosure regarding such a nomination procedure triggering event? Will this disclosure allow sufficient time for a security holder to effectively exercise the nomination procedure? Should this disclosure instead be required on a different form?

L.6. We are proposing to delete as duplicative Item 77C of Form N-SAR, which currently requires disclosure regarding matters submitted to a vote of security holders similar to that required by Item 4 of Part II of Exchange Act Form 10-Q, and move this disclosure to Form N-CSR. Should this disclosure remain in Form N-SAR?

L.7. Should a fund be required to disclose on Exchange Act Form 8-K the date by which a security holder or security holder group must submit the notice to the fund of its intent to require its nominees on the fund's proxy card? Should funds instead be permitted to provide this disclosure in a different manner?

B. Related Rule Changes

1. Beneficial Ownership Reporting Requirements

a. Discussion

Any person who is directly or indirectly the beneficial owner of more than 5% of a class of equity securities registered under Section 12 of the Exchange Act must report that ownership by filing an Exchange Act Schedule 13D with the Commission.¹⁶⁵ There are exceptions to this requirement, however, that permit such a person to report that ownership on Exchange Act Schedule 13G rather than Exchange Act Schedule 13D.¹⁶⁶ One exception permits filings on Exchange Act Schedule 13G for a specified list of qualified institutional investors who have acquired the securities in the ordinary course of their business and not with the purpose nor with the effect of changing or influencing control of the company. A second exception applies to persons who are not specified in the first exception. These beneficial owners of more than 5% of a subject class of securities may file on Exchange Act Schedule 13G if they have not acquired the securities with the purpose nor with the effect of changing or influencing control of the company and they are not directly or indirectly the beneficial

owner of 20% or more of the subject class of securities.

Two of the eligibility requirements for a nominating security holder or nominating security holder group under proposed Exchange Act Rule 14a-11 relate to that security holder or group filing an Exchange Act Schedule 13G to report their ownership. The first is that the security holder or group would have to be eligible to report their ownership on Exchange Act Schedule 13G, rather than Exchange Act Schedule 13D. The second is that the security holder or group would be required to have filed an Exchange Act Schedule 13G to report their ownership by the date that the nominating security holder or nominating security holder group submits its notice of intent to nominate a director to the company.¹⁶⁷

Central to Exchange Act Schedule 13G eligibility is that the security holder be a passive investor that has acquired the securities without the purpose nor with the effect of changing or influencing control of the company. In addition, security holders who are filing as qualified institutional investors must have acquired the securities in the ordinary course of their business. We believe that the formation of a security holder group solely for the purpose of nominating a director pursuant to proposed Exchange Act Rule 14a-11, the nomination of a director, soliciting activities in connection with such a nominee, or having a nominee elected as a director under the proposed procedure, should not be viewed as having a purpose or effect of changing or influencing control of the company. We therefore believe that beneficial owners who engage in these activities should be permitted to report on Exchange Act Schedule 13G, rather than Exchange Act Schedule 13D. Accordingly, we are proposing to add an instruction to the description of the first and second categories of persons who may report their ownership on Exchange Act Schedule 13G to make clear our belief that a beneficial owner who acquires or holds a company's securities in connection with a nomination, soliciting activities, or election of a nominee under Exchange Act Rule 14a-11 should not be deemed to have a purpose or effect of changing or influencing the control of the company solely by virtue of making the nomination or engaging in such activities. Any activity other than those provided for under Exchange Act Rule

¹⁶² See Section IIA2a, above.

¹⁶³ See Release No IC-24816 (Jan. 2, 2001) [66 FR 3734, 3737].

¹⁶⁴ 17 CFR 240.10A-3.

¹⁶⁵ See Exchange Act Rule 13d-1.

¹⁶⁶ See, e.g., Exchange Act Rules 13d-1(b) and 13d-1(c).

¹⁶⁷ This requirement would not extend the date by which the beneficial ownership report is otherwise due under Exchange Act Regulation 13D.