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Expert Analysis

Court Finds Implied Private Right of Action Under the Investment Company Act

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With the significant surge in mutual fund litigation over the last five years, one advantage enjoyed by investment adviser defendants was the courts' consistent refusal to imply private causes of action under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–80b-21.

Despite many class actions and derivative suits attempting to assert such claims, no court had found an implied private right of action since 2002.

On Feb. 19, however, a federal district court in California broke rank, finding that Section 13(a) of the ICA conferred an implied private right of action. *Northstar Fin. Advisors v. Schwab Invs.*, No. 08-CV-4119, 2009 WL 415616 (N.D. Cal. Feb. 19, 2009). (On April 27, the court granted the defendants' motion to certify the ruling for immediate appeal to the 9th U.S. Circuit Court of Appeals.)

While the *Northstar* ruling should not invite new arguments for implied rights under other provisions of the ICA, the ruling already has encouraged new claims by class-action plaintiffs under Section 13(a).

Section 13(a) covers only a very narrow range of conduct,[1] but given the limited availability to bring private claims under the ICA, the plaintiffs' bar will undoubtedly try to stretch its provisions beyond their plain meaning in an attempt to challenge a wider range of conduct by fund advisers.

Brief History of Implied Rights of Action Under the ICA

The only provision of the ICA that provides for an express private right of action is Section 36(b), which relates only to the fees charged to mutual funds.[2] However, beginning in the 1960s, many district courts began permitting plaintiffs to bring actions under several other sections of the ICA, including Section 13(a), holding that these provisions conferred a private right of action.[3]

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For example, while the statutory text and the legislative history indicate that Section 36(a)[4] was designed as a broad catchall to be enforced by the Securities and Exchange Commission, not private plaintiffs, several courts, relying on post-enactment legislative history, found a private right of action under Section 36(a).[5] Thus, private plaintiffs were able to invoke Section 36(a) and use it to bring broad-ranging claims under generalized, federally created fiduciary duty concepts. As a result, plaintiffs were able to challenge a broad array of conduct, creating a more uncertain business environment with increased litigation costs.

In 2001 the Supreme Court in *Alexander v. Sandoval* offered new guidance on the issue of implied private rights of action under federal statutes, signaling a strong presumption against such rights.[6] The following year the 2nd U.S. Circuit Court of Appeals applied *Sandoval* in assessing whether implied private rights of action existed under several provisions of the ICA. In *Olmsted v. Pruco Life Insurance Co.*, the 2nd Circuit refused to find an implied private right of action under either Section 26(f) or 27(i) of the ICA.[7] In so ruling, the court found it significant that these provisions did not contain any "rights-creating" language and instead merely identified certain prohibited conduct.[8]

It was also important to the *Olmsted* court that Section 42 of the ICA explicitly provides for enforcement of all ICA provisions by the SEC.[9] The court reasoned, moreover, that Congress' express provision for a private right of action under Section 36(b) and the absence of such language in other sections of the ICA were strong evidence that Congress did not intend to confer such a right beyond Section 36(b).[10]

Olmsted marked a fundamental shift in how courts approached implied rights under the ICA. Following *Olmsted*, courts consistently refused to find implied private rights of action under various sections of the ICA.[11] Where plaintiffs attempted to rely on decisions predating *Sandoval* and *Olmsted* (that had found implied rights under the ICA), those decisions were dismissed as part of an "*ancien regime*."[12] Prior to the *Northstar* decision, no court since *Olmsted* had found an implied private right to exist under any provision of the ICA.

The Court's Decision in Northstar

In *Northstar* the plaintiff brought a purported class action on behalf of certain investors in the Schwab Total Bond Market Fund against the fund's investment adviser, among others.[13] The plaintiffs claimed that the defendants violated Section 13(a) by deviating from the fund's investment objective to track the Lehman Bros. U.S. Aggregate Bond Index.[14]

The defendants moved to dismiss the complaint, arguing, among other things, that no private right of action could be implied under Section 13.[15] The court rejected this argument, relying heavily on an amendment to Section 13 effectuated by the Sudanese Accountability and Divestment Act of 2007.[16]

The 2007 Amendment to Section 13

SADA was enacted in 2007 with the goal of ending the Darfur genocide by cutting off funding to enterprises that supported Sudan's dictatorial regime.[17] To that end, SADA provides investment advisers (and others) certain latitude to divest from companies that support the current Sudanese government.[18] SADA amended Section 13 of the ICA by adding subsection (c), titled "limitation on actions." Subsection (c)(1) provides, in relevant part:

> *Notwithstanding any other provision of federal or state law, no person may bring any* civil, criminal, or administrative *action* against any registered investment company, or any … investment adviser thereof, based solely upon the investment company *divesting* from, or avoiding investing in, securities issued by persons that the investment company determines … conduct or have direct investments in the business operations of Sudan.[19]

Congress intended Section 13(c) to allow "fund managers to cut ties, at their discretion, with companies involved in" Sudan and to provide "protection from lawsuits"[20] by creating a "safe harbor" for investment advisers that chose to divest from those companies.[21]

The *Northstar* Court's Rationale in Holding An Implied Right Exists Under Section 13

In implying a private right of action under Section 13(a), the *Northstar* court found it significant that newly added Section 13(c) "expressly limited the types of actions that a 'person' could file under Section 13," noting that "[i]f there were no private right of action under Section 13(a), there would be no need to restrict the actions that could be filed under Section 13."[22]

The court rejected the defendants' argument that Section 13(c) was intended as a stand-alone "safe harbor" provision that applied to all state and federal causes of action and thus could not be read as having any specific impact on the meaning of Section 13(a).[23]

Moreover, while the court acknowledged that *Olmsted* strongly suggested that private rights of action cannot be implied under the ICA, it discounted *Olmsted* on the theory that it "predated the amendment of Section 13."[24]

Finally, in support of a finding of implied rights, the court highlighted the fact that Congress, in enacting Section 13(c), did not expressly state "that there was no private enforcement of Section 13."[25]

The Conduct at Issue in *Northstar*

The plaintiff in *Northstar* alleged that the Schwab fund deviated from its investment strategy in two ways.[26] The plaintiff claimed that:

- While fund documents represented to investors that it would track the performance of the Lehman Bros. U.S. Aggregate Bond Index, the Fund improperly invested in securities that were significantly more risky than those in the index; and
- The fund had invested more than 25 percent of its assets in mortgage-backed securities, notwithstanding a concentration policy that prohibited the fund from investing more than 25 percent in any single industry.[27]

The *Northstar* court found that these alleged facts were sufficient to survive a motion to dismiss. The court held that, "Whether the fund's investments in … CMOs [the riskier securities] were, in fact, inconsistent with its investment objective of tracking the index, is a factual matter that cannot be resolved on the pleadings," and, "Whether the fund violated the concentration policy … turns on whether mortgage-backed securities are properly considered an 'industry,' a factual matter which the parties presently dispute."[28]

Analysis of the Northstar *Decision*

While plaintiffs will undoubtedly rely on *Northstar* to convince other courts to find an implied private right of action under Section 13(a), there are a number of arguments that can be made that significantly undermine *Northstar*'s rationale. These include:

- The *Northstar* court improperly relied upon congressional enactments in 2007 (Section 13[c]) to give meaning to ICA provisions that were enacted in 1940 (Section 13[a]). It is settled law that subsequent legislation discloses little or nothing as to the intent of Congress in enacting earlier laws.[29]
- Even if SADA were somehow relevant to Congress' intent in 1940, the core rationale of *Northstar* is faulty. The plain text of Section 13(c) prohibits lawsuits of *any and all kinds* –– civil/criminal, federal/state, legal/equitable, and under common law, statute or regulation — based on divestment from Sudan.[30] The legislative history confirms that Section 13(c) was intended to be a complete, blanket protection against all lawsuits.[31] Thus, Congress' use of "person" was clearly designed to limit claims beyond Section 13(a), including state law claims for breach of fiduciary duty.[32] As such, there was little basis for the *Northstar* court to place such emphasis on the fact that Section 13(c) "limited the types of actions that a '*person*' could file under Section 13" and to conclude from that a private right of action exists under Section 13(a). Because use of the term "person" was necessary to effectuate the broad prohibition against all types of lawsuits, not just those under 13(a), it does not speak, one way or the other, to private rights under Section 13(a).
- To the extent that Section 13(c) impacts claims under Section 13(a), it was likely focused on the SEC. Prior to SADA, the SEC can and did enforce violations of the ICA, including Section 13(a).[33] In so much as Section 13(c) and its use of the term "person" applies to Section 13(a), the most logical reading is that it prohibits the SEC, not private plaintiffs, from bringing actions under 13(a) based on divestment from Sudan. Indeed, Section 13 was amended at the same time to ensure that the definition of "person" included governmental entities.[34]
- Nothing in the text or legislative history of the 2007 amendment adding Section 13(c) reflects a legislative intent to grant a private right of action under Section 13(a). To the contrary, Congress intended, via Section 13(c), to *limit* the types of actions that can be brought under

any state or federal law, and that limitation relates to very narrow conduct (**i.e.**, divestment from Sudanese companies).

- *Northstar* ignores the fact that SADA was intended to benefit investment advisers. One critical question in determining whether an implied right of action exists is whether the plaintiff "is one of the class for whose especial benefit the statute was enacted."[35] While the *Northstar* court did not analyze this issue, it is plain that Section 13(c) — the purported source of the implied right — was *not* intended to benefit fund shareholders. Instead, it was intended to benefit investment advisers by prohibiting lawsuits based on divestment from Sudan. Fund shareholders, such as the plaintiffs in *Northstar*, are simply not members of a class that the statute intended to benefit.

- *Northstar* fails to consider the sound underlying reasoning of *Olmsted*. Nothing in Section 13(a) can be characterized as "rights-creating" language — like the ICA provisions at issue in *Olmstead*, Section 13(a) simply lists prohibitions. The same is true with respect to Section 13(c). Moreover, *Northstar* ignores that Section 42 of the ICA explicitly provides for enforcement by the SEC and fails to consider that Congress, in amending the ICA in 2007, did not expressly provide for a private right of action under Section 13(a), as it had for Section 36(b) in 1970. While SADA came after *Olmstead*, these bedrock tenets of statutory construction should not be ignored.

- *Northstar* also ignores the presumption against judicially created private rights of action where Congress failed to expressly provide for one.[36] In fact, *Northstar* essentially *reversed* this presumption, reasoning that Congress' *failure* to state that "there *was no* private enforcement of Section 13 whatsoever" supported a finding of implied rights.

Implications of the Northstar *Decision*

The reasoning of *Northstar* should provide no support for implying private rights of action under any provision of the ICA beyond Section 13(a). The *Northstar* ruling was based entirely on the 2007 amendment to Section 13, and the court limited its holding — and, importantly, its reasoning — to that section. Thus, even if one agreed with *Northstar*, it would be nearly impossible to extend its holding or rationale beyond Section 13. *Olmsted* and its progeny likely will continue to be relied upon by courts to reject implied causes of action under all other sections of the ICA.

However, *Northstar* has already led to new claims being filed against investment advisers under Section 13(a), and more may follow. Historically, when courts have found (or suggested) that the securities laws provide for a private cause of action, the class-action plaintiffs' bar has tried to stretch the limits of those findings. Creative plaintiffs' lawyers often "interpret" statutory language beyond its plain and/or intended meaning in order to challenge a broader range of alleged misconduct.[37] While Section 13(a) is quite narrow, plaintiffs may attempt to expand its scope. For example, one recently filed complaint included "mismanagement"-type claims under Section 13(a), alleging that ill-advised investments were inconsistent with investment policy set forth in the registration statement.[38]

Importantly, plaintiffs' main avenue of bringing disclosure and mismanagement claims against fund advisers has been under the Securities Act of 1933, 15 U.S.C. §§ 77a–77aa, or the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78lll.[39] Permitting plaintiffs to pursue claims under Section 13(a) of the ICA may allow the plaintiffs' bar to bypass certain procedural and substantive hurdles that exist under the Securities Act or Exchange Act. For example, claims brought under both the Securities Act and the Exchange Act are subject to the limitations and requirements imposed by the Private Securities Litigation Reform Act of 1995,[40] such as more stringent pleading standards for securities fraud claims and automatic stays of discovery during the pendency of a motion to dismiss.[41] These heightened procedural standards of the PSLRA do not apply to the ICA.[42] Moreover, substantively, many claims under the Securities Act and Exchange Act require plaintiffs to plead and prove certain well-established elements, such as *scienter*, materiality and loss causation.[43] Whether courts will require similar elements under Section 13(a) remains to be seen.[44]

Conclusion

For much of the last decade, it was settled law that private rights of action would not be implied under the ICA. *Northstar* has changed the legal landscape to a certain extent. While it is unlikely that *Northstar* will

dramatically alter the implied-rights jurisprudence that has developed since *Olmstead* — in that *Northstar* will likely not apply beyond Section 13(a) — it remains to be seen whether other courts will allow private actions under Section 13(a). If the history of implied rights under the ICA is any indicator, the plaintiffs' bar will undoubtedly test the bounds of Section 13(a).

Notes

1 Section 13(a) of the ICA, 15 U.S.C. § 80a-13(a), provides, "No registered investment company, unless authorized by the vote of a majority of its outstanding voting securities, shall: change its subclassification as defined in Section 80a-5(a)(1) and (2) of this title or its subclassification from a diversified to a non-diversified company; borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities or make loans to other persons, except in each case in accordance with the recitals of policy contained in its registration statement in respect thereto; deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to Section 80a-8(b)(3) of this title; or change the nature of its business so as to cease to be an investment company."

2 *See* 15 U.S.C. § 80a-35(b).

3 *See, e.g., Fogel v. Chestnut,* 668 F.2d 100, 111 (2d Cir. 1981) (recognizing implied right of action under the ICA); *Blatt v. Merrill Lynch, Pierce, Fenner & Smith,* 916 F. Supp. 1343, 1357 (D.N.J. 1996) (finding implied right of action under ICA Section 13); *Potomac Capital Mkts. Corp. v. Prudential-Bache Corporate Dividend Fund,* 726, F. Supp. 87, 93 n.5 (S.D.N.Y. 1989) (same); *see also Meyer v. Oppenheimer Mgmt. Corp.,* 764 F.2d 76, 86-88 (2d Cir. 1985) (finding implied right of action under Section 15(f) of the ICA); *Bancroft Convertible Fund v. Zico Inv. Holdings,* 825 F.2d 731, 736 (3d Cir. 1987) (same as to Section 12(d)(1)(a) of the ICA); *Lessler v. Little,* 857 F.2d 866, 873 (1st Cir. 1988) (same as to Section 17(a)(2) of the ICA); *Jerozal v. Cash Reserve Mgmt.,* No. 81 Civ. 1569, 1982 WL 1363, at *4-6 (S.D.N.Y. Aug. 10, 1982) (same as to Sections 15 and 47(a) of the ICA); *In re Nuveen Fund Litig.,* No. 94 C 360, 1996 WL 328006, at *5 (N.D. Ill. June 11, 1996) (same as to Section 34(b) of the ICA).

4 Section 36(a) provides in full: "The commission is authorized to bring an action in the proper district court of the United States or in the U.S. court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts (1) as officer, director, member of any advisory board, investment adviser, or depositor or (2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company. If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in Section 1(b) of this title, 15 U.S.C. § 80a-35(a)."

5 *See, e.g., Tannenbaum v. Zeller,* 552 F.2d 402, 417 (2d Cir. 1977) (holding that an implied private right of action exists under Section 36(a)); *McLachlan v. Simon,* 31 F. Supp. 2d 731 (N.D. Cal. 1998) (same); *Young v. Nationwide Life Ins.,* 2 F. Supp. 2d 914 (S.D. Tex. 1998) (same).

6 532 U.S. 275 (2001) (holding that regulations promulgated under Section 602 of Title VI of the Civil Rights Act of 1964 did not create a private right of action); *see id.* at 287 ("Having sworn off the habit of venturing beyond Congress' intent [in holding that private causes of action exist], we will not accept [the plaintiffs'] invitation to have one last drink.").

7 283 F.3d 429, 432, 436 (2d Cir. 2002).

8 *See id.* at 432-33; *see also Sandoval,* 532 U.S. at 289 ("Statutes that focus on the person regulated rather than the individuals protected create 'no implication of an intent to confer rights on a particular class of persons.'").

9 *See Olmsted,* 283 F.3d at 433.

10 *See id.*

11 *See, e.g., Bellikoff v. Eaton Vance Corp.,* 481 F.3d 110, 117 (2d Cir. 2007) (finding no implied private right of action under Sections 34(b), 36(a), and 48(a) of the ICA); *Alexander v. Allianz Dresdner Asset Mgmt. of Am. Holding,* 509 F. Supp. 2d 190, 194 (D. Conn. 2007) (same); *Boyce v. AIM Mgmt. Group,* No. H-04-2587, 2006 WL 4671324, at *2 (S.D. Tex. Sept. 29, 2006) (same as to Sections 34(b) and 36(a), citing numerous cases in support); *In re Dreyfus Mut. Funds Fee Litig.,* 428 F. Supp. 2d 342, 347-49 (W.D. Pa. 2005) (same); *DH2 Inc. v. Athanassiades,* 359 F. Supp. 2d 708, 720 (N.D. Ill. 2005) (same as to Section 17(j)); *meVC Draper Fisher Jurvetson Fund I v. Millennium Partners,* 260 F. Supp. 2d 616, 624-35 (S.D.N.Y. 2003) (same as to Section 12(d)(1)); *White v. Heartland High-Yield Mun. Bond Fund,* 237 F. Supp. 2d 982, 987 (E.D. Wis. 2002) (same as to Sections 22 and 34(b)).

12 *See Olmsted,* 283 F.3d at 434; *accord In re Am. Mut. Funds Fee Litig.,* No. CV 04-5593-GAFRNBX, 2005 WL 3989803, at *3 (C.D. Cal. Dec. 16, 2005).

13 *See* 2009 WL 415616, at * 1. The court did find that the complaint failed to properly plead standing but provided plaintiff leave to cure the deficiency. *See id.* at *2.

14 *Id.* at *1.

15 *Id.* at *3-8.

16 *Id.*

17 *See* 110 Cong. Rec. S15373-74 (daily ed. Dec. 12, 2007) (statement of Sen. Dodd).

18 *Id.*

19 Sudan Accountability and Divestment Act of 2007, Pub. L. No. 110-174, Section 4 (codified at 15 U.S.C. § 80a-13(c)) (emphasis added). SADA contained a similar "safe harbor" provision for certain pension plan fiduciaries. ***See id.*** at Section 5.

20 *See* Dodd statement, *supra* note 17.

21 110 Cong. Rec. H16756 (daily ed. Dec. 18, 2007) (statement of Rep. Lee); *see also id.* at H16757 (statement of Rep. Frank) ("[SADA] empowers entities that want to withdraw funding to do so without fear of lawsuit.").

22 *Northstar,* 2009 WL 415616 at *5.

[23] *Id.* ("[I]f Congress intended for Section 13(c) to operate as a stand alone 'safe harbor' provision, Congress easily could have added Section 13(c) as an entirely new provision of the ICA rather than amending Section 13, or could have stated that there was no private enforcement of Section 13 whatsoever.").

[24] *Id.*

[25] *Id.*

[26] *Id.* at *5.

[27] *Id.* at *6-8.

[28] *Id.* at *7-8.

[29] *See Sandoval,* 532 U.S. at 287-88; *SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 199-200 (1963); *United States v. Price,* 361 U.S. 304, 313 (1960) (holding that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one"); *Hagen v. Utah,* 510 U.S. 399, 420 (1994) ("subsequent history is less illuminating than the contemporaneous evidence"); *see also In re Mut. Funds Inv. Litig.,* 384 F. Supp. 2d 845, 870 (D. Md. 2005) ("Likewise, although there were statements in committee reports relating to the 1970 and the 1980 amendments to Section 36 reflecting support for implication of private rights of action under the section, these statements are of little, if any, significance after *Sandoval.*").

[30] *See* 15 U.S.C. § 80a-13(c)(1) ("notwithstanding any other provision of federal or state law, no person may bring any civil, criminal, or administrative action against") (emphasis added).

[31] *See* notes 18-22, *supra.*

[32] *See id.; see also* 15 U.S.C. § 80a-13(c)(2).

[33] *See, e.g., In the Matter of Parnassus Invs. et al.,* S.E.C. Release No. ID-131, 1998 WL 558996 (Sept. 3, 1998).

[34] *See* 15 U.S.C. §§ 80a-13(c)(2), 41.

[35] *Cort v. Ash,* 422 U.S. 66, 78 (1975).

[36] *See Olmsted,* 283 F.3d at 432 ("A court … cannot ordinarily conclude that Congress intended to create a right of action when none was explicitly provided."); *In re Eaton Vance Mut. Funds Fee Litig.,* 380 F. Supp. 2d 222, 232 (S.D.N.Y. 2005) ("The absence of rights-creating language, the existence of an alternative method of enforcement and the existence of an explicit private right of action for another provision of the statute creates the strong presumption that Congress did not intend to create private rights of action" under the ICA.).

[37] *See, e.g., Benak v. Alliance Capital Mgmt. L.P.,* No. Civ. A. 01-5734, 2004 WL 1459249, at *7 (D.N.J. Feb. 9, 2004) ("However, the import of the legislative history behind the enactment of Section 36(b) does not support plaintiff's theory; namely, that a plaintiff can utilize Section 36(b) in hindsight as a vehicle to challenge an investment adviseor's performance regarding a particular aspect of the overall services provided.").

[38] *See* Complaint, *Tackmann v. Oppenheimer Funds,* No. 3:09cv01184 (N.D. Cal. Mar. 18, 2009). *Tackmann* is pending before Judge Susan Illston, who also decided *Northstar*.

[39] *See, e.g., In re Charles Schwab Corp. Sec. Litig.,* No. C 08-01510 WHA, 2009 WL 262456 (N.D. Cal. Feb. 4, 2009) (class action alleging that defendants violated, *inter alia,* Sections 11 and 12(a)(2) of the Securities Act and by misrepresenting the risk profile of the Schwab YieldPlus Fund and by improperly changing the fund's investment policies).

[40] *See* Private Securities Litigation Reform Act of 1995, Pub L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of Title 15 of the U.S. Code).

[41] *See* generally 15 U.S.C. §§ 77z-1, 78u-4 (imposing procedural burdens on private securities litigations brought under the Securities Act and the Exchange Act).

[42] *See In re Smith Barney Transfer Agent Litig.,* No. 05 Civ. 7583(WHP), 2006 WL 1738078, at * 3 (S.D.N.Y. June 26, 2006) ("ICA claims … fall outside the purview of the PSLRA").

[43] *See, e.g.,* 15 U.S.C. § 77k(a) (imposing liability for, *inter alia,* false statements of material fact in registration statement or prospectus of a security); *Dura Pharms. v. Broudo,* 544 U.S. 336, 341-42 (2005) (holding that in a Section 10b-5 action, plaintiff must prove, among other things, a material misrepresentation, ***scienter*** and loss causation).

[44] It should be noted, claims under Section 13(a) of the ICA are likely to be derivative in nature, which would subject them to the requirements of Federal Rule of Civil Procedure 23.1.

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