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COURT RECOGNIZES AN IMPLIED PRIVATE RIGHT OF ACTION UNDER THE INVESTMENT COMPANY ACT OF 1940

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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 consistent refusal by courts to imply private causes of action under the Investment Company Act of 1940 (the "ICA"). 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 February 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. *See Northstar Financial Advisors, Inc. v. Schwab Investments, Inc.*, No. C 08-4119 SI, 2009 WL 415616 (N.D. Cal. Feb. 19, 2009). While the *Northstar* ruling should not invite new arguments for implied rights under other provisions of the ICA, the ruling could encourage new claims by class action plaintiffs under Section 13(a). Section 13(a) covers only a very narrow range of conduct,[1] but the plaintiffs' bar will undoubtedly try to stretch it beyond its plain language in an attempt to challenge a wide range of conduct by fund advisers.

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 is limited to conduct relating to the fees charged to mutual funds.[2] Since the 1960s, however, many district courts had permitted plaintiffs to bring actions

[1] Section 13(a) of the ICA, 15 U.S.C. § 80a-13(a), provides that:

> No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—
> (1) 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;
> (2) 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;
> (3) 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
> (4) change the nature of its business so as to cease to be an investment company.

[2] *See* 15 U.S.C. § 80a-35(b).

arising from several other sections of the ICA, including Section 13(a), holding that these provisions conferred a private right of action.[3]

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.[4] The following year, the Second Circuit Court of Appeals applied *Sandoval* in assessing whether implied private rights of action existed under provisions of the ICA. In *Olmsted v. Pruco Life Ins. Co. of N.J.*, a case handled by Milbank attorneys, the Second Circuit refused to find an implied private right of action under either Section 26(f) or 27(i) of the ICA.[5] In so ruling, the court found it significant that these provisions did not contain any "rights-creating" language, but instead merely identified certain prohibited conduct.[6] 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.[7] The court reasoned, moreover, that Congress's express provision for a private right of action under Section 36(b), and the absence of such language in other sections of the ICA, was strong evidence that Congress did not intend to confer such a right.[8]

Olmsted marked a fundamental shift in how courts approached implied rights under the ICA. Following *Olmsted*, courts consistently refused to find such rights.[9] Where plaintiffs attempted to rely on decisions (that had found implied rights under the ICA) predating *Sandoval* and *Olmsted*, those decisions were dismissed as part of an "*ancien regime*."[10] 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*, plaintiff brought a purported class action on behalf of certain investors in the Schwab Total Bond Market Fund ("Fund") against the Fund's investment adviser, among others.[11] Plaintiff claimed that defendants had violated Section 13(a) by deviating from the Fund's Investment objective to track the Lehman Brothers U.S. Aggregate Bond Index.[12] Defendants moved to dismiss the complaint arguing, among other things, that no private right of action could be implied under Section 13(a).[13] The court rejected this argument, relying heavily upon an amendment to Section 13 effectuated by the Sudanese Accountability and Divestment Act of 2007 ("SADA").[14]

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[3] *See, e.g.*, *Brown v. Bullock*, 194 F. Supp. 207, 221-27 (S.D.N.Y. 1961) (recognizing implied right of action under Section 37(a) of the ICA); *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981) (recognizing implied right of action under the ICA); *Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 916 F. Supp. 1343, 1357 (D.N.J. 1996) (finding implied right of action under Section 13); *Potomac Capital Mkts. Corp. v. Prudential-Bache Corporate Dividend Fund, Inc.*, 726 F. Supp. 87, 93 n.5 (S.D.N.Y. 1989) (same); *see also Meyer v. Oppenheimer Mgmt. Co.*, 764 F.2d 76, 86-88 (2d Cir. 1985) (finding implied right of action under Section 15(f) of the ICA); *Bancroft Convertible Fund, Inc. v. Zico Inv. Holdings Inc.*, 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. Fund*, 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 *6 (N.D. Ill. June 11, 1996) (same as to Section 34(b) of the ICA).

[4] 532 U.S. 275, 293 (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's intent [in holding that private causes of action exist], we will not accept [plaintiffs'] invitation to have one last drink.").

[5] 283 F.3d 429, 432, 436 (2d Cir. 2002).

[6] *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.'").

[7] *See Olmsted*, 283 F.3d at 433.

[8] *See id.*

[9] *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 Amer. Holding, Inc.*, 509 F. Supp. 2d 190, 194 (D. Conn. 2007) (same); *Boyce v. AIM Mgmt. Group, Inc.*, 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, Inc. v. Millennium Partners, L.P.*, 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)).

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

[11] *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.

[12] *See id.* at *1.

[13] *See id.* at *3-8.

[14] *See id.*

The 2007 Amendment to Section 13

The SADA was enacted in 2007 with the goal of cutting off funding to enterprises that supported Sudan's dictatorial regime.[15] To that end, the SADA provides investment advisors (and others) certain latitude to divest from companies that support the current Sudanese government.[16] The SADA amended Section 13 of the ICA by adding subsection (c), entitled "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 business operations in Sudan.[17]

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"[18] by creating a "safe harbor" for investment advisers that chose to divest from those companies.[19]

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."[20] The court rejected 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).[21] 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."[22] 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 . . . . "[23]

The Conduct at Issue in Northstar

The plaintiff in *Northstar* alleged that the Fund deviated from its investment strategy in two ways.[24] Plaintiff claimed that: (1) while Fund documents represented to investors that the Fund would track the performance of the Lehman Brothers U.S. Aggregate Bond Index, the Fund improperly invested in securities that were significantly more risky than those in that index; and (2) the Fund had invested more than 25% of its assets in mortgage-backed

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[15] *See* 153 Cong. Rec. S15373-74 (daily ed. Dec. 12, 2007) (statement of Sen. Dodd).
[16] *See id.*
[17] Sudan Accountability and Divestment Act of 2007, Pub. L. No. 110-174, § 4 (codified at 15 U.S.C. § 80a-13(c)). The SADA contained a similar "safe harbor" provision for certain pension plan fiduciaries. *See id.* at § 5.
[18] 153 Cong. Rec. S15373-74 (daily ed. Dec. 12, 2007) (statement of Sen. Dodd).
[19] 153 Cong. Rec. H16756 (daily ed. Dec. 18, 2007) (statement of Rep. Lee); *see also id.* at H16757 (statement of Rep. Frank) ("[the SADA] empowers entities that want to withdraw funding to do so without fear of lawsuit").
[20] *Northstar,* 2009 WL 415616, at *5
[21] *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.").
[22] *Id.*
[23] *Id.*
[24] *Id.* at *5.

securities, notwithstanding a concentration policy that prohibited the Fund from investing more than 25% in any single industry.[25] The court found that these alleged facts were sufficient to survive a motion to dismiss. The Court held that: (1) "[w]hether 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 (2) "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."[26]

Analysis of the Northstar Decision

We believe that there are very strong arguments that *Northstar* was incorrectly decided. Should investment advisers face new claims under Section 13(a), there are many arguments that can be made to undermine *Northstar*'s finding of an implied private right of action under Section 13(a). These include the following:

- The *Northstar* court improperly relied upon Congressional enactments in 2007 (the addition of new 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 about the intent of Congress in enacting earlier laws.[27]

- Even if the SADA was somehow relevant to Congress's 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.[28] The legislative history confirms that Section 13(c) was intended to be a complete, blanket protection against all lawsuits.[29] Thus, Congress's use of "person" was clearly designed to limit claims beyond Section 13(a), including state law claims for breach of fiduciary duty.[30] 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 that a private right of action exists under Section 13(a). Because the reference to "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).

- Nothing in the text or legislative history of the 2007 amendment adding Section 13(c) reflects a legislative intent to imply 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, and that limitation relates to a very narrow type of conduct (*i.e.*, divestment from Sudanese companies).

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[25] *Id.* at *6-8.
[26] *Id.* at *7-8.
[27] *See Sandoval*, 532 U.S, 287-88; *SEC v. Capital Gains Research Bureau, Inc.*, 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*.").
[28] *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).
[29] *See* fn. 19, *supra*.
[30] *See id.; see also* 15 U.S.C. § 80a-13(c)(2).

- *Northstar* ignores the fact that the SADA was intended to benefit investment advisors. 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?"[31] It is plain that Section 13(c)—the purported source of the implied right—was intended to benefit investment advisors by prohibiting lawsuits. Fund shareholders, such as the plaintiffs in *Northstar*, are simply not a member 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 *Olmsted*, 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 the SADA came after *Olmsted*, these bedrock tenets of statutory construction should not be ignored.

- Finally, *Northstar* ignores the presumption against judicially-recognized private rights of action where Congress failed to expressly provide for one.[32] Worse, *Northstar* essentially *reverses* this presumption, reasoning that Congress's *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. The *Northstar* ruling was based entirely on the 2007 amendment to Section 13, and the court limited its holding and reasoning to that section. Even if one agreed with *Northstar*, there does not appear to be any basis 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* may lead to new claims being filed against investment advisers under Section 13(a). Historically, when courts found (or suggested) that the securities laws provide for a potential cause of action, the class action plaintiffs' bar has tried to stretch the limits of those findings.[33] While Section 13(a) is quite narrow, plaintiffs may attempt to expand its scope. For example, *Northstar* may invite misguided attempts by plaintiffs to pursue "mismanagement" claims under Section 13(a), alleging that ill-advised investments were inconsistent with investment policy set forth in the registration statement.

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

[32] *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.).

[33] *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 § 36(b) does not support Plaintiff's theory; namely, that a plaintiff can utilize § 36(b) in hindsight as a vehicle to challenge an investment advisor's performance regarding a particular aspect of the overall services provided.").

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