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Ninth Circuit Rejects Private Right Of Action To Enforce Section 13(a) Of The Investment Company Act Of 1940

In *Northstar Financial Advisors, Inc. v. Schwab Investments*, No. 09-16347, 2010 WL 3169400 (9th Cir. Aug. 12, 2010), the United States Court of Appeals for the Ninth Circuit held that nothing in Section 13(a) of the Investment Company Act of 1940 ("ICA"), as originally enacted or as subsequently amended, either created a private right of action or implied that such a right exists with the clarity and specificity required under United States Supreme Court precedent. In so holding, the Ninth Circuit followed the Second Circuit and the recent trend of federal courts to reject implied private rights of action under the ICA.

The action centered around claims by investors that a large American investment trust operating a series of mutual funds unlawfully deviated from the investment policies set forth in its registration statement, to the detriment of the fund's shareholders and in violation of Section 13(a) of the ICA. That provision generally requires an investment company to obtain shareholder approval before deviating from the investment policies contained in the company's registration statement filed with the Securities and Exchange Commission ("SEC"). Defendant-Appellant Schwab Investments is an investment trust organized under Massachusetts law that consists of a series of mutual funds. In 1993, Schwab Investments initiated the Schwab Long-Term Government Bond Fund. By vote of that fund's shareholders in 1997, Schwab Investments converted the fund into the Schwab Total Bond Market Fund ("Fund"), a fixed-income mutual fund that sought to track the Lehman Brothers U.S. Aggregate Bond Index ("Lehman Index"). The Fund hired Defendant-Appellant Charles Schwab Investment Management, Inc. ("Charles Schwab") as its investment advisor.

Plaintiff-Appellee Northstar Financial Advisors, Inc. ("Northstar") is a registered investment advisory and financial planning firm that manages discretionary and nondiscretionary accounts on behalf of investors and had over 200,000 shares of the Fund under its management. In August 2008, Northstar filed this shareholder class action in United States District Court for the Northern District of California against Schwab Investments and Charles Schwab (collectively, "Schwab") for violations of Section 13(a) of the ICA. Northstar sought to represent a class of investors who owned shares of the Fund from August 31, 2007, to the present. Northstar's primary claim was that Schwab violated Section 13(a) when it allegedly deviated from the Fund's fundamental investment policies. Northstar alleged that the deviations exposed the Fund and its shareholders to tens of millions of dollars in losses stemming from a sustained decline in the value of non-

agency mortgage-backed securities. Schwab moved to dismiss for failure to state a claim under Section 13(a) of the ICA, asserting that there was no private right of action to enforce that section's terms. The district court denied the motion, upholding an implied private right of action under Section 13(a). Recognizing, however, that the question was not free from doubt, the district court certified its decision for interlocutory appeal. The Ninth Circuit accepted the appeal, and reversed and remanded.

The Ninth Circuit reasoned that whether there exists a private right to enforce Section 13(a) of the ICA is a question of statutory construction, and, hence, the statute must either explicitly create a private right of action or implicitly contain one. Since both parties in the appeal agreed that Section 13(a) did not expresslycreate a private right of action, the Ninth Circuit held that if a private right to enforce existed, it must be implied from the statute's language, structure, context and legislative history. The Ninth Circuit first analyzed the language and structure of the statute itself.

In looking at the language of Section 13(a) and the structure of the ICA, generally, the Ninth Circuit looked for the presence of any "rights-creating language" that may have implied that Congress intended to confer upon shareholders the right to sue an investment company for violating the statute's requirements. The Ninth Circuit held that the language of Section 13(a) and the structure of the ICA, generally, granted the *SEC* broad authority to investigate suspected violations, initiate actions in federal court for injunctive relief or civil penalties, and create exemptions from compliance with any ICA provision. The Ninth Circuit held that this thorough delegation of authority to the SEC to enforce the ICA strongly suggested that Congress intended to preclude othermethods of enforcement, including private rights of action. The Supreme Court had also cautioned that "where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it." *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19 (1979). Hence, because the statutory scheme of the ICA provides for thorough SEC enforcement of the ICA's provisions, including Section 13(a), the Ninth Circuit followed the United States Supreme Court and held that "it is highly improbable that Congress absentmindedly forgot to mention an intended private action."

Furthermore, the Ninth Circuit held that it is evident from the text of the ICA that Congress knew how to create a private right of action to enforce a particular section of the Act if it wished to do so. Indeed, the Ninth Circuit pointed to two provisions in the ICA wherein Congress expressly authorized private suits for damages. First, in Section 30(f) of the original ICA, Congress expressly authorized private suits for damages against insiders of closed-end investment companies who make short-swing profits. Congress created a second express private right of action in 1970 when it added Section 36(b) to the ICA, which allows shareholders to sue an investment company's advisor and its affiliates for breach of certain fiduciary duties relating to management fees. The Ninth Circuit held that Congress's enactment of these two express private rights of action elsewhere in the ICA, without the enactment of a corresponding express private right of action to enforce Section 13(a), indicates that Congress did not, by its silence, intend a private right of action to enforce Section 13(a).

The Ninth Circuit then analyzed the legislative history of the ICA. Northstar argued that even if the ICA's language did not imply a private right to sue, the statute's legislative history, specifically the amendments to Sections 8 and 13 enacted in 1970 and 2007, demonstrated that Congress intended there to be an implied private right of action to enforce Section 13(a). The Ninth Circuit disagreed, holding instead that "nothing in the language or context of those amendments demonstrat[ed] *a clear congressional intent* to allow private lawsuits to enforce the statute's provisions" (emphasis added).

In concluding, the Ninth Circuit held that neither the language of Section 13(a), the structure of the ICA, nor the statute's legislative history, including the amendments in 1970 and 2007, reflected any congressional intent to create, or recognize a previously established, private right of action to enforce Section 13(a). Thus, "the job of enforcement remains exclusively with the SEC." Prior to this case, the Ninth Circuit had not decided the issue, but the Second Circuit had held that that there was no private right to enforce five other sections of the ICA, reasoning, in relevant part, that the purpose and structure of the entire ICA is grounded upon enforcement by the SEC, not on private enforcement. In holding with the Second Circuit, the Ninth Circuit's decision highlights that federal courts have come to require increasingly specific congressional direction for the allowance of private suits to enforce public laws, and unless such direction is present in the statute, federal courts are reluctant to imply such a right.

For further information, please contact John Stigi at (310) 228-3717 or Taraneh Fard at (213) 617-5492.