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9th Circuit Curbs the Rising Tide of Subprime Litigation and Rejects a Private Right of Action for Violation of Investment Objectives

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In a case of first impression, on August 12, 2010 the Ninth Circuit overruled the Northern District Court of California, and found that there is no private right of action for investors to enforce Section 13(a) of the Investment Company Act of 1940 (the "ICA" or the 1940 Act). Section 13 (a) of the ICA compels an investment company to obtain shareholder approval before deviating from the investment policies in the company's registration statement filed with the Securities and Exchange Commission (the "SEC"). The district court had found that investors themselves could bring actions against mutual funds for any decisions that depart from stated investment policies. This decision could have opened the door to a new field of class actions requiring the courts to examine day-to-day fund management to determine whether the funds had departed from their stated "fundamental" investment policies. However, the Northern District Court recognized the possible impact of its holding and certified its decision for interlocutory appeal and subsequent Ninth Circuit review.

The Ninth Circuit's decision adheres to the recent trend in federal court decisions, which have generally followed the Second Circuit in rejecting plaintiffs' requests for private rights of action under the ICA. These developments regarding the 1940 Act are consistent with the Supreme Court's strict construction of statutory language in construing private rights of action in the broader securities field, as shown in the recent Supreme Court decision, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008). Had the Ninth Circuit allowed mutual funds to be subject to judicially created private rights of action, it would have been in direct contrast with the last decade of federal decisions and spurred additional unnecessary litigation.

Background to the ICA

Following the enactment of the Securities Act of 1933 and the Securities Act of 1934, which regulate corporate securities, the ICA was enacted in 1940 to provide regulation of investment companies and the mutual fund industry. Section 13 of the ICA specifically provided for the protection of investment company shareholders by prohibiting investment companies from changing certain investment policies included in their registration statements without first obtaining shareholder approval.[1] To enforce these safeguards, Congress gave the SEC the authority to enforce the 1940 Act and bring actions in federal court for injunctive relief or civil penalties. *See* 15 U.S.C. § 80(a)-41(d)-(e).

Subsequently, in 2007 Congress amended the ICA in response to the ongoing acts of genocide in Darfur, Sudan. Congress had imposed economic sanctions on Darfur and then found that in order to not penalize companies for complying with the sanctions, they needed to add a "safe harbor" for divestment decisions that went against stated investment policies but were made in compliance with the new restrictions. Therefore, Congress rewrote ICA Section 13(c) to add a "safe harbor" for those investment companies who had to make divestments from investments in Sudan. Revised Section 13(c)(1) stated, "[n]otwithstanding any other provision of Federal or State law, no ***person*** may bring any civil, criminal, or administrative action against any registered investment company…based solely upon the investment company divesting from…[securities] described in section 3(d) of the Sudan Accountability and Divestment Act of 2007" (emphasis added).

The Northstar Decision

In *Northstar Financial*, the Northstar plaintiffs argued, amongst other claims, that when Congress amended the ICA, it recognized a preexisting private right of action to enforce Section 13(a).[2] The plaintiffs argued that defendant Schwab Investments had violated Section 13(a) by deviating from the fund's investment objective to track the Lehman Brothers U.S. Aggregate Bond Index. According to Northstar, these deviations, as opposed to the general recession, exposed shareholders to tens of millions of dollars in losses due to the steady decline in the value of non-agency mortgage-backed securities. Ultimately, the District Court agreed with the plaintiffs and found that these million dollar losses could be challenged by private individuals under Section 13(a). While examining the Schwab defendants' appeal, Ninth Circuit Judge Mary Schroeder acknowledged that the issue of the existence of a private cause of action to enforce Section 13(a) of the ICA had not been decided in that Circuit, but chose to follow the Second Circuit. In so doing, she reversed the District Court, which had explicitly rejected the Second Circuit's line of reasoning because of the intervening Sudanese Amendments.[3] According to Judge Schroeder, when Congress used the word "person" to describe the entities restricted from bringing the types of actions barred by Section 13(c), it was not used in recognition of a private right of action, but instead as a means of describing the variety of entities restricted from bringing acts barred by Section 13(c).[4] In support of this argument, the court reviewed the case law from other circuits on this issue and found that the courts were trending towards denying the existence of an implied private right of action under the ICA.[5]

Courts Have Generally Not Expanded Private Rights of Action Under the ICA

In the last decade, courts have shown a marked trend towards denouncing any private right of action under the ICA. Perhaps the most significant cases demonstrating this trend are *Bellikoff v. Eaton Vance Corp.,* 481 F.3d 110 (2d Cir. 2007) and *Olmsted v. Pruco Life Ins. Co. of New Jersey*, 283 F.3d 429 (2d Cir. 2002). In *Bellikoff*, the Second Circuit held that because other sections of the ICA clearly created a private right of action for investors against investment companies, the omission of such language in Sections 34(b), 36(a), and 48(a) of the 1940 Act, clearly demonstrated that there was no implied private right of action.[6] Had Congress wished to create such a private right, it could have used such an express provision as was employed in other Sections, implying that Congress intentionally did not include such a right.[7] Similarly, in *Olmsted*, the court reasoned that the explicit inclusion of a private right to action under 15 U.S.C. § 80a-35(b) implied that the omission of such a private right for Section 80a-27(i) was clearly intentional.[8] These decisions have been followed by a series of federal court holdings that deny the existence of an implied private right of action under the ICA.[9]

The Supreme Court Has Emphasized that Private Rights of Action Should Not Be Liberally Recognized

The federal court rulings concerning the limited existence of private rights of action under the ICA correspond with the Supreme Court's general trend of rejecting implied private rights of action. In 2001, the Supreme Court heard the case of *Alexander v. Sandoval*, 532 U.S. 275 (2001), concerning whether there was a private right of action under Title VI of the Civil Rights Act of 1964. The respondent in *Sandoval* argued that the petitioner's policy of only administering driver's license examinations in English had a discriminatory impact on non-English speakers.[10] The Court, however, found that there was nothing in Title VI that displayed a Congressional intent to create a private enforcement right of action and therefore found that no such right existed.[11]

Similarly, in the more recent case of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008), the Supreme Court found that there was no private right of action against aiders and abettors of securities fraud. In *Stoneridge,* the plaintiffs alleged losses after purchasing common stock, and sought to recoup those losses from entities that never made statements that the investors relied upon in buying or selling the stock.[12] The Court denied these grounds for liability, finding that the court should not create a private cause of action against aiders and abettors because "the decision to extend the cause of action is for Congress."[13]

Conclusion

While the courts have again shown an unwillingness to extend private rights of action, the *Northstar* decision does not guarantee a safe haven for investment decisions that deviate from stated objectives. The SEC has enforcement authority under the ICA, and SEC Chair Mary Schapiro has stated that the Agency has stepped up enforcement since the financial crisis began.[14] In fact, the SEC has permanently expanded the enforcement division's subpoena power by eliminating review of a subpoena request by the agency's five commissioners.[15] Therefore, investment companies and advisors should be aware that while the Ninth Circuit has rejected a private right of action under Section 13(a), the SEC has continued enforcement responsibility under Section 13(a).

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[1] For example, 15 U.S.C. § 80(a)-13(a) states in relevant part, "No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities … (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."

[2] *Northstar Financial Advisors, Inc. v. Schwab Investments*, No. 09-16347, 2010 LEXIS 16706, at *25 (9th Cir. Aug. 12, 2010).

[3] *Id*. at 35.

[4] *Id*. at 36.

[5] *Id*. at 41.

[6] *Bellikoff v. Eaton Vance Corp*., 481 F.3d 110, 116 (2d Cir. 2007).

[7] *Id*.

[8] *Olmsted v. Pruco Life Ins. Co. of New Jersey*, 283 F.3d 429, 433 (2d Cir. 2002).

[9] *See, e.g., W. Inv. LLC v. DWS Global Commodities Stock Fund, Inc.*, F. Supp. 2d, No. 10 Civ. 1399, 2010 WL 1404208, at *3-4 (S.D.N.Y. Apr. 5, 2010) (finding that there is no private right of action under the ICA provisions that prohibit investment companies from deviating from fundamental investment policies); *In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579, 591-93 (S.D.N.Y. 2006) (holding that in determining whether statutes create private rights of action, an express provision granting a private right implies that the provision was specifically excluded elsewhere) (following *Olmsted v. Pruco Life Ins.Co. of New Jersey*, 283 F.3d 429, 433 (2d Cir. 2002)).

[10] *Alexander v. Sandoval*, 532 U.S. 275, 279 (2001).

[11] Id. at 293.

[12] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153 (2008).

[13] *Id*. at 165.

[14] Marcy Gordon, *SEC Chief Says Enforcement Has Increased*, Associated Press, (July 20, 2010, 3:54 PM), *available at* http://news.yahoo.com/s/ap/20100720/ap_on_bi_ge/us_sec_financial_overhaul.

[15] Zachary A. Goldfarb, *SEC enforcement division granted permanent subpoena powers*, The Washington Post (August 12, 2010), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/08/11/AR2010081106274.html.