No. ______

IN THE

# Supreme Court of the United States

SCHWAB INVESTMENTS, et al.,

*Petitioners,*

v.

NORTHSTAR FINANCIAL ADVISORS, INC., on behalf of itself and others similarly situated,

*Respondent.*

**ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT**

## PETITION FOR WRIT OF CERTIORARI


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Dated: July 27, 2015

## QUESTIONS PRESENTED

This Court has explained that, in determining a plaintiff's standing to sue under Article III, the relevant inquiry is whether the plaintiff had "the requisite stake in the outcome when the suit was filed." *Davis v. Federal Election Commission*, 554 U.S. 724, 734 (2008). Following this rule, several courts of appeals have held that a plaintiff that lacks Article III standing at the time of filing cannot cure this defect by acquiring a claim or interest thereafter. Rejecting this rule and creating a conflict among the courts of appeals, the Ninth Circuit below held exactly the opposite. The first question presented is: (1) whether a plaintiff who lacked Article III standing at the time it filed its complaint may subsequently cure this defect by later acquiring a claim or interest and then amending its complaint to allege its post-filing acquisition.

After rejecting the time-of-filing rule, the Ninth Circuit then proceeded to recognize a novel common-law breach-of-contract cause of action based on a mutual fund's disclosures filed with the Securities and Exchange Commission. The second question presented is: (2) whether a mutual fund's mandatory SEC disclosures may constitute a "contract" between the fund and its investors sufficient to support a private common-law breach-of-contract action against the fund distinct from other rights of action available under the federal securities laws.

## PARTIES TO THE PROCEEDING AND CORPORATE DISCLOSURE STATEMENT

Petitioners in this proceeding are all Defendants-Appellees below: Schwab Investments; Mariann Byerwalter, Donald F. Dorward, William A. Hasler, Robert G. Holmes, Gerald B. Smith, Donald R. Stephens, Michael W. Wilsey, Charles R. Schwab, Randall W. Merk, Joseph H. Wender and John F. Cogan as Trustees of Schwab Investments; and Charles Schwab Investment Management, Inc.

Pursuant to Supreme Court Rule 29.6, the above-named Petitioners state that Charles Schwab Investment Management is wholly owned by the Charles Schwab Corporation, which is publically held. No corporation owns 10% or more of the shares of Charles Schwab Corporation. Defendant Schwab Investments is a Massachusetts Business Trust that is owned beneficially by its public shareholders. No corporation owns 10% or more of the beneficial interests of the trust.

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## OPINIONS BELOW

The opinion of the Ninth Circuit, as amended on denial of rehearing and rehearing en banc, holding that Respondent Northstar Financial Advisors, Inc. ("Northstar") had Article III standing to proceed on its claims against Petitioners and that Northstar properly alleged the existence of a contract between Schwab Investments and the shareholders of the Schwab Total Bond Market Fund, Pet. App. 1a, is available at 779 F.3d 1036 (9th Cir. 2015). The opinion of the United States District Court for the Northern District of California holding that Northstar's supplemental pleading established Article III standing, Pet. App. 89a, is available at 781 F. Supp. 2d 926 (N.D. Cal. 2011). The opinion of the United States District Court for the Northern District of California dismissing Northstar's breach-of-contract claim, Pet. App. 171a, is available at 609 F. Supp. 2d 938 (N.D. Cal. 2009). In a prior decision, the Ninth Circuit determined that Northstar could not assert a private right of action under section 13(a) of the Investment Company Act of 1940. *Northstar Fin. Advisers, Inc. v. Schwab Invs.*, 615 F.3d 1106 (9th Cir. 2010); Pet. App. 130a.

## JURISDICTION

The Ninth Circuit issued its initial opinion on March 9, 2015, and issued its opinion denying rehearing and rehearing en banc on April 28,

2015. Pet. App. 1a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1). The Ninth Circuit had jurisdiction pursuant to 28 U.S.C. § 1291. The district court had jurisdiction pursuant to 28 U.S.C. §§ 1332(d)(2) and 1367.

## CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS

The relevant provisions of U.S. CONST. art. III, § 2, 15 U.S.C. §§ 77p(b), 77p(f), 77r(a)(1), 77r(a)(2), 77r(b)(2), 77r(c)(1), 77v(a), 77z-2, 80a-8(b) and 80a-13(a), and 17 C.F.R. §§ 230.485 and 230.497 are reprinted at Pet. App. 201 pursuant to Supreme Court Rule 14(f).

## STATEMENT OF THE CASE

Petitioner Schwab Investments (the "Trust") is a series of business trusts organized under Massachusetts law that operated several mutual funds, including the Schwab Total Bond Market Fund (the "Fund"). Pet. App. 8a, 13a. Petitioner Charles Schwab Investment Management, Inc. (the "Advisor") acted as the investment advisor to the Fund. Pet. App. 12a. In 1997, as required under the Investment Company Act of 1940 ("ICA"), 15 U.S.C. § 80a-8(b), the Trust sought shareholder approval for a modification to the Fund's investment objectives whereby: (1) the Fund would seek to track the performance of the Lehman Brothers [U.S.] Aggregate Bond Index (the "Lehman Index");

and (2) the Trust would not invest more than twenty-five percent of the Fund's total assets in any one industry. Pet. App. 13a, 32a-33a. The Fund's shareholders adopted both proposals, and both policies were disclosed in the Fund's registration statement and subsequent prospectuses as "fundamental" policies. Pet. App. 7a, 13a-14a.

Northstar is a registered investment advisor that invested its clients' money in the Fund. Pet. App. 14a-15a. In August 2008, Northstar filed a lawsuit against the Trust, its trustees, and the Advisor, alleging that the Fund improperly deviated from its fundamental policies by failing to track the Lehman Index. Pet. App. 15a, 172a-173a. Northstar did not own any shares of the Fund itself at the time it filed its complaint (or at any time prior thereto), but rather asserted claims on behalf of its clients who had invested in the Fund. Pet. App. 18a. The complaint asserted four causes of action: (1) a private right of action under section 13(a) of the ICA; (2) a claim for breach of fiduciary duty; (3) a claim for breach of contract between the Fund's shareholders and the Trust, based upon the 1997 proxy statement and subsequent prospectuses; and (4) a claim for violation of the implied contractual covenant of good faith and fair dealing. Pet. App. 33a. Only Northstar's breach-of-contract theories are relevant to this Petition.

The district court initially dismissed Northstar's complaint without prejudice, finding that because Northstar did not own any shares of the Fund, it had not alleged an injury in fact and lacked constitutional standing to pursue its claims. Pet. App. 176a. However, the court allowed Northstar the opportunity to amend its complaint. In doing so, it noted that "Northstar cannot bring claims on behalf of its clients simply by virtue of its status as an investment advisor" but that "[t]he assignment of claims from one of Northstar's clients would ... cure this deficiency." Pet. App. 176a-177a.

Northstar then obtained an assignment of claims from one of its clients on December 8, 2008—more than three months after filing its original complaint, and thereafter amended its complaint to allege the fact of the assignment. Pet. App. 92a. Petitioners again moved to dismiss, arguing that, "because standing must be determined at the time a complaint is filed and because Northstar did not obtain an assignment of claims until several months after the original complaint was filed, the assignment cannot cure Northstar's original lack of standing." Pet. App. 96a. Following reassignment of the case to a new judge, the district court rejected Petitioners' standing argument. Pet. App. 98a. The court construed the prior judge's earlier decision allowing Northstar to amend its complaint as an order granting leave to file a supplemental complaint under Federal Rule of Civil Procedure

15(d)[1] and held that standing was properly established based on the post-filing assignment of the client's claims to Northstar. Pet. App. 98a-99a. The court then rejected Petitioners' argument that standing had to exist at the time of the original complaint as "elevat[ing] form over substance." Pet. App. 98a. At the same time, however, the district court dismissed Northstar's breach-of-contract claim on the merits, ruling that the Fund's proxy statement and prospectuses, which established the fundamental policies that could not be changed without shareholder approval, did not form a contract between the Fund's shareholders and the Trust. Pet. App. 119a.

On appeal, the Ninth Circuit upheld the district court's ruling that Northstar had standing, but reversed the dismissal of the contract claims. The court observed that "Rule 15(d) permits a supplemental pleading to correct a defective complaint and circumvents 'the needless formality and expense of instituting a new action when events occurring after the

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[1] Rule 15(d) states: "On motion and reasonable notice, the court may, on just terms, permit a party to serve a supplemental pleading setting out any transaction, occurrence, or event that happened after the date of the pleading to be supplemented. The court may permit supplementation even though the original pleading is defective in stating a claim or defense." Fed. R. Civ. P. 15(d).

original filing indicated a right to relief.'" Pet. App. 20a (quoting Wright, Miller, & Kane, Federal Practice and Procedure: Civil 3d § 1505 at 262–63). Citing the decisions of other courts that have allowed supplemental pleadings stating post-filing events to cure a lack of statutory subject-matter jurisdiction, the court concluded that a post-filing assignment of claims could likewise cure a lack of standing in this instance. *Id.*

As to Northstar's contract claims, the Ninth Circuit reversed the district court's decision that Northstar had failed to allege that a contract existed and held that "the mailing of the proxy statement and the adoption of the two fundamental investment policies after the shareholders voted to approve them, and the annual representations by the Fund that it would follow these policies are sufficient to form a contract between the shareholders on the one hand and the Fund and the Trust on the other." Pet. App. 48a-49a.

Judge Bea dissented on the ground that Northstar's lack of constitutional standing at the time the original complaint was filed could not be cured by a post-filing assignment of claims. Pet. App. 85a. Among other things, Judge Bea noted that the majority's decision allows "[u]ninjured parties, particularly those in search of class action lead plaintiff status, [to] sue first, then trawl for those truly and timely injured," and effectively "green-lights those who would race to the courthouse and bend Federal Rules of Civil Procedure and Article III standing requirements to gain an edge over other claimants who are not as fleet of foot." Pet. App. 87a-88a. Because he concluded that Northstar lacked standing, Judge Bea did not reach the merits of the claims.

## REASONS FOR GRANTING THE WRIT

This Petition involves two independent issues: (1) Northstar's standing to sue under Article III notwithstanding its lack of a requisite stake in the outcome at the time it filed its complaint, and (2) Northstar's novel breach-of-contract theory. Turning first to the standing question, this Court has long followed the general rule that a court's subject-matter jurisdiction "depends upon the state of things at the time of the action brought." *Keene Corp. v. United States*, 508 U.S. 200, 207 (1993) (quoting *Mollan v. Torrance*, 9 U.S. (1 Wheat.) 537, 539 (1824) (Marshall, C.J.)). While it is true that exceptions to this "time-of-filing" rule exist in certain contexts, this Court has never recognized the exception the Ninth Circuit allowed below, namely that a plaintiff who unquestionably lacks Article III standing at the time it files its complaint may subsequently acquire standing thereafter by taking an assignment of claims and then amending its original complaint to add notice of this post-filing assignment. Other courts of appeals have squarely rejected this practice as inconsistent with the requirements of Article III. *See Abraxis Bioscience, Inc. v. Navinta LLC*, 625 F.3d 1359, 1366 (Fed. Cir. 2010); *SunCom Mobile & Data, Inc. v. Fed. Commc'ns Comm'n,* 87 F.3d 1386, 1389 (D.C. Cir. 1996). Likewise, this Court has determined that, for purposes of Article III, "the standing inquiry remains focused on whether the party invoking jurisdiction had the requisite stake in the outcome when the suit was filed." *Davis v. Fed. Election Comm'n*, 554 U.S. 724, 734 (2008). Given the conflict between the courts of appeals on this question, and likewise the conflict between the decision below and this Court's precedents, certiorari is warranted.

Certiorari is further warranted because the standing question is undoubtedly important. Under the rule followed by other courts of appeals, federal courts must dismiss the complaints of litigants who lack the requisite standing at the time of filing. Under the Ninth Circuit's rule, however, litigants who lack the requisite standing at the time of filing may nonetheless proceed with their suits for some indeterminate period, affording them the opportunity to acquire standing in some way later on if they are able. The Ninth Circuit's approach thus unavoidably invites the pursuit of speculative litigation, contrary to the purpose of the time-of-filing rule and the requirements of Article III. This case presents an ideal vehicle to resolve the disagreement among the courts of appeals over this important standing question because the issue is presented squarely in this matter and is outcome-determinative.

In addition, certiorari is warranted because the Ninth Circuit's decision improperly conflates *constitutional* standing under Article III with *statutory* jurisdictional analysis—a matter that has generated confusion among the lower courts. In reaching its standing determination in this case, the Ninth Circuit mistakenly relied on exceptions to the time-of-filing rule applicable to certain statutory jurisdictional requirements. These statutory exceptions, however, do not govern the analysis of constitutional standing to bring suit under Article III, which standing must exist, without exception, at the time a complaint is filed.

Regarding the breach-of-contract issue, certiorari is warranted because, in proceeding to the merits of a case the court did not have proper jurisdiction to decide, the court recognized an unprecedented breach-of-contract cause of action that is fundamentally at odds with federal securities laws. Specifically, the court concluded that mandatory disclosures filed with the Securities and Exchange Commission may constitute a "contract" between a mutual fund and its investors sufficient to support a private common-law right of action for breach. That conclusion, however, is contradicted by, among other things, the decisions of other courts that have rejected similar claims, Congress's systematic legislative efforts to provide for the uniform federal regulation of nationally traded securities, and this Court's reluctance to recognize novel common-law causes of action in the securities area.

The breadth of the Ninth Circuit's novel theory of liability is sweeping. By effectively permitting an end-run around existing legislative safeguards and reforms embodied in the federal securities laws, it threatens to expand significantly the pursuit of securities litigation in the federal courts in ways that conflict with Congress's comprehensive efforts to limit such litigation. For these and other reasons, the second question presented is of exceptional importance and likewise warrants this Court's review.

## I. Certiorari Is Warranted On The Standing Question Because The Ninth Circuit's Decision Conflicts With The Decisions Of Other Courts Of Appeals, Is Inconsistent With This Court's Precedents, Involves An Exceptionally Important Issue, And Was Decided Incorrectly On Grounds That Have Generated Confusion Among The Lower Courts.

Article III of the Constitution limits the judicial power of the federal courts to actual "cases" or "controversies." U.S. CONST., art. III § 2. There is no question that Northstar did not own any shares in the Fund when it filed its original complaint (or at any time prior thereto) and that Northstar could not allege an actual "case or controversy" at the time of filing. The Ninth Circuit, however, ruled that Northstar's lack of constitutional standing was properly cured by the assignment of claims to Northstar by one of its clients three months after Northstar first filed its complaint. Pet. App. 20a-21a, 92a. The court reasoned that, because Federal Rule of Civil Procedure 15(d) allows parties to file a supplemental pleading "setting out any transaction, occurrence, or event that happened after the date of the [original] pleading," and because other courts have allowed supplemental pleadings to cure statutory jurisdictional defects that existed at the time of filing, Northstar's constitutional standing defect could also be cured post-filing. Pet. App. 20a. The Ninth Circuit's ruling, however, directly conflicts with the decisions of at least two other Circuit Courts; is contrary to this Court's precedents establishing that Article III standing must exist at the time the complaint is filed; presents a vitally important question; and reflects confusion among the lower courts on the differences between statutory jurisdictional requirements and Article III standing. Certiorari is therefore warranted.

### A. The Ninth Circuit's Standing Decision Conflicts With The Decisions Of Other Courts Of Appeals On The Issue Of Whether A Plaintiff Who Lacks Article III Standing At The Time It Files A Complaint May Subsequently Acquire Standing And Cure The Constitutional Defect.

The Ninth Circuit's holding regarding Northstar's standing conflicts squarely with the decisions of other federal courts of appeals. For example, in *Abraxis Bioscience, Inc. v. Navinta LLC*, 625 F.3d 1359, 1366-67 (Fed. Cir. 2010), the Federal Circuit reversed the district court's ruling in favor of Abraxis on its patent infringement claims against Navinta because the patents in question had not yet been assigned to Abraxis at the time the original complaint was filed, and Abraxis therefore lacked constitutional standing. The court began its discussion by noting that "[s]tanding is a constitutional requirement pursuant to Article III and it is a threshold jurisdictional issue." *Id.* at 1363. As such, "[a] court may exercise jurisdiction only if a plaintiff has standing to sue *on the date it files suit*." *Id.* at 1364 (citing *Keene Corp. v. United States*, 508 U.S. 200, 207 (1993)) (emphasis added). Because Abraxis did not hold enforceable title to the patent on the day the suit was filed, it lacked standing and the court ruled that "the suit must be dismissed, and the jurisdictional defect cannot be cured by ... the subsequent purchase of an interest in the patent in suit." *Id.* at 1366 (quoting *Schreiber Foods, Inc. v. Beatrice Cheese, Inc.*, 402 F.3d 1198, 1203 (Fed. Cir. 2005)). As a result, the Federal Circuit reversed the district court's ruling and dismissed the case based on Abraxis's lack of standing even though trial of its claims had already occurred and Abraxis prevailed. *Id.* at 1368. The fact that Abraxis had filed an amended complaint stating it had been assigned the rights to the patents after the original complaint was filed could not cure the defect because the constitutional standing requirement "cannot be met retroactively." *Id.* at 1366 & n.3.

The Federal Circuit repeatedly has adhered to this line of reasoning. *See, e.g., Innovative Therapies, Inc. v. Kinetic Concepts, Inc.*, 599 F.3d 1377, 1384 (Fed. Cir. 2010) (standing for purposes of declaratory judgment action could not be established based on events occurring after original complaint was filed); *Paradise Creations, Inc. v. UV Sales, Inc.*, 315 F.3d 1304, 1309-1310 (Fed. Cir. 2003) (company lacked standing to pursue complaint filed while company was administratively dissolved, and subsequent reinstatement after complaint's filing could not cure defective standing); *Gaia Tech., Inc. v. Reconversion Tech., Inc.*, 93 F.3d 774, 779-80 (Fed. Cir. 1996) (plaintiff that did not own the patents and trademarks at issue at the time of filing lacked standing to pursue the litigation because "[p]ermitting non-owners and licensees the right to sue, so long as they eventually obtain the rights they seek to have redressed, would enmesh the judiciary in abstract disputes, risk multiple litigation, and provide incentives for parties to obtain assignments in order to expand their arsenal and the scope of litigation" (quoting *Procter & Gamble Co. v. Paragon Trade Brands, Inc.*, 917 F. Supp. 305, 310 (D. Del. 1995))).[2]

[2] The Ninth Circuit below relied on another Federal Circuit case, *Prasco LLC v. Medicis Pharm. Corp.*, 537 F.3d 1329, 1337 (Fed. Cir. 2008), in which the court looked to an amended complaint that included actions taken after the filing of the initial complaint to determine Article III standing. The flawed reasoning of *Prasco* is not only in conflict with other cases in the Federal Circuit, but also with its own acknowledgement that "[l]ater events may not create jurisdiction where none existed at the time of filing." *Id.* at 1338. Moreover, *Prasco* relies upon this Court's decision in *Mathews v. Diaz*, 426 U.S.

The District of Columbia Circuit likewise has held that Article III standing deficiencies cannot be cured post-filing. *See SunCom Mobile & Data, Inc.* 87 F.3d 1386 (D.C. Cir. 1996). In that case, SunCom petitioned the Federal Communications Commission ("FCC") for a declaration that a proposed wide-area band transmission network complied with FCC rules and a waiver of the FCC's eight-month deadline for building out the network. *Id.* at 1387. The FCC denied both requests. *Id.* On appeal, the appellate court concluded that SunCom lacked standing because at the time the petition was filed it did not own the licenses necessary to create its network and, therefore, the court saw "no likelihood that SunCom stood to suffer the kind of concrete, probable harm from the Commission's denials that Article III requires." *Id.* at 1388. Most importantly, the court held that SunCom could not subsequently cure its lack of standing by entering into agreements with the license holders after the complaint was already filed because, as the court noted, the initiation of the litigation was the "critical time for Article III standing analysis." *Id.* at 1389.

The Ninth Circuit's decision in this case is irreconcilable with these decisions of the Federal Circuit and the D.C. Circuit. Here, the Ninth

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67 (1976), a case that, as explained below, does not involve Article III standing. *See* Section D.

Circuit allowed a plaintiff that lacked constitutional standing at the time it filed its complaint to cure this defect by acquiring standing through an assignment of claims more than three months after the complaint was filed. This result is clearly at odds with the decisions discussed above that hold, without exception, that if a plaintiff lacks Article III standing at the time of filing "the suit must be dismissed, and the jurisdictional defect cannot be cured" by subsequent events. *Abraxis*, 625 F.3d at 1366.

### B. The Decision Below Conflicts With This Court's Precedents Establishing That Article III Standing Must Exist At The Time A Complaint Is Filed.

The decision below also conflicts with the precedents of this Court stating that, for purposes of Article III standing, the "inquiry remains focused on whether the party invoking jurisdiction had the requisite stake in the outcome *when the suit was filed*." *Davis v. Fed. Election Comm'n*, 554 U.S. 724, 734 (2008) (emphasis added). This statement tracks the general, longstanding time-of-filing rule that "the jurisdiction of the court depends upon the state of things at the time of the action brought." *Mollan v. Torrance*, 9 U.S. (1 Wheat.) 537, 539 (1824). Citing *Mollan*, this Court recently applied the general time-of-filing rule in the diversity setting, and in doing so explained the basis for the rule in terms that apply equally in the context of standing under Article III. *See Grupo Dataflux v. Atlas Global Group, L.P.*, 541 U.S. 567, 581-82 (2004). Although the Court has also long recognized that, in an appropriate case, a litigant may be permitted to amend a defective complaint to clarify that it actually had standing at the time of filing, *see, e.g., Warth v. Seldin*, 422 U.S. 490, 501 (1975), this opportunity does not include the ability to use allegations of post-filing events to cure a lack of standing at the time of filing. Rather, in the Article III context, the time-of-filing rule articulated in cases such as *Davis* properly controls and the court below should have followed it.

This Court has explained that an "essential aspect" of Article III's case or controversy limitation is that a plaintiff must demonstrate standing to invoke the power of the federal courts. *Hollingsworth v. Perry*, 133 S. Ct. 2652, 2661 (2013).[3] The Court's precedents likewise firmly establish that a plaintiff must satisfy the requirements for standing at the time the

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[3] The "irreducible constitutional minimum" requirements for standing are: (1) an injury to the litigant that is both concrete and particular and actual or imminent; (2) a causal connection such that the injury is "fairly ... trace[able] to the challenged action of the defendant;" and (3) a likelihood that the injury will be "redressed by a favorable decision." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61 (1992) (internal citations omitted).

complaint is filed. *Davis*, 554 U.S. at 734; *see also Hollingsworth*, 133 S. Ct. at 2661 (noting that "standing cases consider whether a plaintiff has satisfied the requirement when filing suit"). Here there is no question that Northstar did not satisfy this requirement. Thus, Northstar lacked Article III standing at the time it filed its complaint and the complaint should have been dismissed.

In an analogous context, the Court recently reinforced the importance of adhering to the time-of-filing rule in *Grupo Dataflux*. In that case, diversity jurisdiction did not exist when the complaint was filed, but, after filing, the two limited partners whose presence defeated diversity subsequently sold their interests. 541 U.S. at 569. The Court held that the case should still be dismissed for lack of subject-matter jurisdiction, declining to break from 175 years of precedent that "jurisdiction depending on the condition of the party is governed by that condition, as it was at the commencement of the suit." *Id.* at 571 (quoting *Conolly v. Taylor*, 27 U.S. (2 Pet.) 556, 565 (1829)).

The court below distinguished *Grupo Dataflux* on the grounds that it involved diversity jurisdiction and, procedurally, did not involve a supplemental pleading. Pet. App. 27a-28a. These cited grounds, however, cannot justify the Ninth Circuit's failure to apply the time-of-filing rule in this matter. Wholly apart from the Court's holding in *Grupo Dataflux* that the time-of-filing rule applies in the diversity context, this Court's precedents also clearly establish a time-of-filing rule for determining Article III standing to sue. *See, e.g., Davis*, 554 U.S. at 734. Likewise, this Court's application of the time-of-filing rule in *Grupo Dataflux* did not depend on the label attached to any particular pleading—specifically, whether it was an "amended" or "supplemental" filing. Standing under Article III also does not turn on such labels. The standing requirements of Article III are constitutional in nature and thus the procedural vehicle used to modify a complaint is not what counts. Rather, what matters is the reality of the facts and circumstances of the litigant's standing at the time suit is first commenced.

The Court's analysis in *Grupo Dataflux* reinforces further the value of the time-of-filing rule, namely that "[u]ncertainty regarding the question of jurisdiction is particularly undesirable, and collateral litigation on the point particularly wasteful." 541 U.S. at 582. As the Court explained, the goal of minimizing litigation over jurisdiction is "thwarted whenever a new exception to the time-of-filing rule is announced, arousing hopes of further new exceptions in the future" and thus fostering wasteful litigation. *Id.* at 581. This principle is similarly compelling in the Article III standing context, where the Court has also refrained from creating exceptions to the time-of-filing rule for purposes of determining whether a particular litigant has the right to commence a lawsuit. By resolving the standing issue in a manner that conflicts with this Court's precedents, the Ninth Circuit's decision affirmatively frustrates these principles.

The facts of this matter are far different from those cases in which a plaintiff actually had standing at the time of filing, but failed to allege sufficient facts to demonstrate the existence of such standing. In those cases, a court may well grant leave to amend to enable the plaintiff to make a more definite statement. For purposes of Article III, however, this possibility of amendment does not include the right to create standing post hoc by amending the complaint to set forth events or circumstances that first arose after filing. As this Court established in *Warth*, 422 U.S. at 501-02 (Powell, J.), "it is within the trial court's power to allow or to require the plaintiff to supply, by amendment to the complaint or by affidavits, further particularized allegations of fact deemed supportive of plaintiff's standing. If, after this opportunity, the plaintiff's standing does not adequately appear from all materials of record, *the complaint must be dismissed*." (emphasis added). And as the Court's subsequent decisions citing *Warth* demonstrate, it is clear what this means: where a complaint insufficiently alleges standing, a court may allow the plaintiff to amend the complaint to demonstrate that standing did in fact exist at the time the complaint was filed if the allegations in the complaint were somehow incomplete. *See Havens Realty Corp. v. Coleman*, 455 U.S. 363, 377-78 (1982) (holding that the plaintiffs' general allegations that, as residents of a large metropolitan area, they were denied benefits of an integrated community were inadequate to demonstrate standing, but that they should have the "opportunity to *make more definite* the allegations of the complaint" (emphasis added); *id.* at 383 (Powell, J., concurring) (confirming that the analysis in *Warth* permitted a district court "to deal with a *vague averment* as to standing by requiring amendment") (emphasis added). At the same time, however, a supplemental pleading cannot create standing based on facts or events that occurred after the complaint was filed. Rather, as the Court stated flatly in *Davis*, "the standing inquiry [under Article III] remains focused on whether the party invoking jurisdiction had the requisite stake in the outcome when the suit was filed." 554 U.S. at 734.

For purposes of the right to commence a lawsuit consistent with the requirements of Article III, this Court's analysis is straightforward and clear: the plaintiff must have standing at the time the complaint is originally filed. The decision below, which allows a plaintiff who unquestionably did not have standing at the time of filing to acquire standing months after filing, is plainly and directly at odds with this Court's precedents. Accordingly, this Court's review is warranted.

### C. This Case Presents An Ideal Opportunity For The Court To Clarify An Exceptionally Important Issue.

The Ninth Circuit's decision to create a new exception to the Article III time-of-filing rule raises a critical issue of constitutional importance, is presented squarely in this case, and is plainly outcome-determinative. In particular, the critical importance of having and maintaining clear and consistent standards for determining Article III standing cannot be overstated. As the Court has explained, the requirement that matters decided in federal courts must present an actual case or controversy "assumes particular importance in ensuring that the Federal Judiciary respects the proper—and properly limited—role of the courts in a democratic society." *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332, 341 (2006) (internal citations and quotation marks omitted); *see also Allen v. Wright*, 468 U.S. 737, 750 (1984) ("[T]he 'case or controversy' requirement defines with respect to the Judicial Branch the idea of separation of powers on which the Federal Government is founded."), *abrogated on other grounds by Lexmark Int'l v. Static Control Components*, 134 S. Ct. 1377 (2014). "If a dispute is not a proper case or controversy, the courts have no business deciding it, or expounding the law in the course of doing so." *DaimlerChrysler*, 547 U.S. at 341. Accordingly, "[n]o principle is more fundamental to the judiciary's proper role in our system of government than the constitutional limitation of federal-court jurisdiction to actual cases or controversies." *Id.* (internal quotation marks omitted).

Allowing plaintiffs who have not suffered an actual injury at the time of filing to pursue claims they do not have turns on its head the essential concept that courts may hear only cases and controversies brought by those who can demonstrate "a 'personal stake' in the alleged dispute." *Raines v. Byrd*, 521 U.S. 811, 819 (1997). As Judge Bea's dissent below highlighted, the majority's decision allows "[u]ninjured parties, particularly those in search of class action lead plaintiff status, [to] sue first, then trawl for those truly and timely injured," and effectively "green-lights those who would race to the courthouse and bend Federal Rules of Civil Procedure and Article III standing requirements to gain an edge over other claimants who are not as fleet of foot." Pet. App. 87a-88a.

Moreover, by creating a new exception to the time-of-filing rule and deciding the merits of the case even though it lacked jurisdiction, the Ninth Circuit "overstep[ped] its assigned role in our system of adjudicating only actual cases and controversies." *Simon v. Eastern Kentucky Welfare Rights Org.*, 426 U.S. 26, 39 (1976). This action is of particular concern here because, after erroneously determining that it had jurisdiction, the court below then proceeded to recognize a novel and unworkable cause of action that conflicts with federal law (as discussed in greater detail subsequently). For this reason as well, the Court's review is warranted.

### D. The Decision Below Reflects A More General Confusion Over Exceptions To The Time-of-Filing Rule That Warrants Clarification.

Relying on the decisions of other courts that have recognized certain limited exceptions to the time-of-filing rule and have allowed post-filing events to cure a lack of subject matter jurisdiction, the Ninth Circuit concluded that Northstar's lack of constitutional standing under Article III could also be cured by a post-filing assignment of claims. Pet. App. 20a. The Ninth Circuit's chief error—and one replicated by some other courts—is its assumption that time-of-filing exceptions to certain statutory jurisdictional requirements may be imported into the jurisprudence of Article III standing. Although the Ninth Circuit is wrong, this is an issue that has confused other courts and warrants clarification.

In large part, the cases that the Ninth Circuit relied upon in reaching its decision involve a court's *statutory* jurisdiction to hear a particular case, not Article III standing. For example, in *Mathews v. Diaz*, 426 U.S. 67, 74-75 (1976) relied upon below, this Court considered whether it had jurisdiction over a claim challenging the residence requirements for Medicare coverage where the applicant had not filed his application for Medicare until after he was joined in the action. The filing of an application was a statutory, not a constitutional, condition of jurisdiction. The Court held that the post-filing application could cure the *statutory* jurisdictional defect, but this holding says nothing about a plaintiff's post-filing ability to cure a *constitutional* standing defect. *Id.* at 75; *see also Rockwell Int'l Corp. v. United States*, 549 U.S. 457, 460 (2007) (considering whether the plaintiff qualified as an "original source" under the False Claims Act); *Feldman v. Law Enforcement Assocs. Corp.*, 752 F.3d 339, 346 (4th Cir. 2014) (amended complaint cured jurisdictional defect where plaintiff's initial claim under Sarbanes-Oxley Act was filed before the 180-day waiting period required by statute had run); *Black v. Sec'y of Health and Human Svcs.*, 93 F.3d 781, 790 (Fed. Cir. 1996) (statutory requirement that a party seeking reimbursement under the National Childhood Vaccine Injury Act demonstrate damages exceeding $1000 could be satisfied with damages incurred after petition was filed); *Travelers Inc. Co. v. 633 Third Assocs.*, 973 F.2d 82, 83 (2d Cir. 1992) (noting that "[t]he sole issue presented is whether plaintiff has standing under sections 274 and 275 of New York's fraudulent conveyance statute"); *M.G.B. Homes, Inc. v. Ameron Homes*, 903 F.2d 1486, 1489 (11th Cir. 1990) (allowing amended complaint to cure jurisdictional defect under Copyright Act); *United Partition Systems, Inc. v. United States*, 59 Fed Cl. 627, 644 (2004) (allowing supplemental pleading to allege post-filing allegations relevant to jurisdictional requirements of Contract Disputes Act).

Not one of these cases calls into question the bedrock principle that Article III standing must be established at the time a lawsuit is commenced. Moreover, although the cases sometimes refer to the plaintiff's "standing" under the particular statute in question, this Court has recently clarified that whether a plaintiff's complaint falls within the "zone of interests" that a statute protects is not truly a question of "standing" *per se*, but rather a question of statutory interpretation. *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 134 S. Ct. 1377, 1387 (2014).[4]

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[4] Even pre-*Lexmark* cases that characterized the "zone of interest" inquiry as a matter of standing considered it a matter of "prudential standing," which is separate and distinct from the Article III constitutional

In its decision below, the Ninth Circuit relied further upon a second set of cases that have permitted statutory jurisdictional defects to be cured post-filing by the addition or removal of a party. *See Newman-Green, Inc. v. Alfonzo-Larrain*, 490 U.S. 826, 837-38 (1989) (allowing a court to drop dispensable non-diverse defendant); *Mullaney v. Anderson*, 342 U.S. 415, 417 (1952) (allowing addition of individual plaintiffs to cure potential jurisdictional defect); *California Credit Union League v. City of Anaheim*, 190 F.3d 997, 999 (9th Cir. 1999) (allowing joinder of United States to establish

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standing requirement. *See, e.g., Valley Forge Christian Coll. v. Americans United for Separation of Church and State*, 454 U.S. 464 (1982) ("[N]either the counsels of prudence nor the policies implicit in the 'case or controversy' requirement should be mistaken for the rigorous Art. III requirements themselves. Satisfaction of the former cannot substitute for a demonstration of 'distinct and palpable injury ... that is likely to be redressed if the requested relief is granted.'") (citation omitted); *Gladstone Realtors v. Village of Bellwood*, 441 U.S. 91 (1979) ("[The standing] inquiry involves both constitutional limitations on federal-court jurisdiction and prudential limitations on its exercise. ... Congress may, by legislation, expand standing to the full extent permitted by Art. III, thus permitting litigation by one 'who otherwise would be barred by prudential standing rules.' In no event, however, may Congress abrogate the Art. III minima: A plaintiff must always have suffered 'a distinct and palpable injury to himself,' that is likely to be redressed if the requested relief is granted.") (citations omitted).

jurisdiction under Tax Injunction Act); *Hackner v. Guaranty Trust Co. of New York*, 117 F.2d 95, 98 (2d Cir. 1941) (allowing addition of party to meet amount in controversy requirement). These cases, however, rely upon Rule 21 of the Federal Rules of Civil Procedure, which expressly allows a court to "at any time, on just terms, add or drop a party." Fed. R. Civ. P. 21. This rule-based exception to the time-of-filing rule plainly did not authorize the Ninth Circuit to establish a novel exception to the requirements of Article III allowing a plaintiff to acquire constitutional standing after the complaint has been filed. The Ninth Circuit's confusion in this case is one that is shared by other courts. In order to clarify this confusion, certiorari is warranted.

## II. The Ninth Circuit's Holding That SEC Disclosures Are Contracts That May Be Enforced Through Common-Law Breach-Of-Contract Claims Is An Exceptionally Important Issue Worthy Of This Court's Review.

After rejecting the time-of-filing rule and holding that Northstar had standing, the Ninth Circuit then held that certain of the Trust's mandatory disclosures—namely, the disclosures identified above in the 1997 proxy statement and the subsequent prospectuses—had the effect of creating a contract between the Trust and the Fund shareholders. In particular, the court held that the statements in the disclosures established a "structural restriction" that, once approved by shareholders, "created a contract," the breach of which could give rise to a common-law breach-of-contract action. Pet. App. 41a. The court explained that "anyone who purchased shares in the Fund after 1997, or held shares that he then owned, was legally and contractually entitled to have his investment managed in accordance with the proposals in the proxy statement, unless the shareholders voted to permit otherwise." *Id.* (internal quotation marks and citation omitted). In other words, the court concluded that a fund's mandatory SEC disclosures may create private liability under common-law breach-of-contract theories.

The importance and harmful consequences of this decision cannot be overemphasized. Northstar's theory is unworkable, misconstrues the role of disclosures under the federal securities laws, and effects an end-run around existing federal safeguards and reforms in the securities area. Further, the Ninth Circuit's decision establishes a far-reaching and deeply flawed cause of action that threatens to expand significantly the pursuit of securities litigation in the federal courts in a manner that conflicts with Congress's sustained legislative efforts to limit such litigation. It is also inconsistent with the decisions of other courts that have rejected similar theories, and likewise this Court's precedents declining to recognize novel common-law theories in the securities context. Such a novel cause of action necessarily and detrimentally impacts the market for nationally traded securities. As this Court has noted, securities constitute "vital elements of our economy," and "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, 78 (2006). Certiorari review is thus warranted on the second question presented.

### A. The Ninth Circuit's Breach-Of-Contract Theory Is Unworkable, Misconstrues And Improperly Sidesteps The Requirements Of The Federal Securities Laws, And Creates A Means To Penalize Mutual Funds For Their Compliance With Federal Law.

The decision below recognizing Northstar's common-law contract claims is plainly at odds with the provisions and requirements of well-defined federal securities laws. Critically, it crafts an unworkable common-law contract theory around a misconstruction of federal disclosure requirements. Disclosures are not contracts, and treating them as such misconstrues both the concept of a "contract" and the role of mandatory SEC disclosures under federal law. Among other things, the Ninth

Circuit's recognition of Northstar's theory improperly circumvents the existing regulatory scheme, and effectively creates a means to punish mutual funds for their compliance with federal disclosure laws.

Mutual fund disclosures are pervasively and comprehensively regulated by the ICA and other federal statutes and regulations, including the Securities Act of 1933 and the Securities Exchange Act of 1934. Critically, the role of disclosures under these laws is not to establish common-law contractual relationships between a fund and its investors, but rather to explain and update periodically the details of the fund's operations—a reality antithetical to the very idea of contract formation.

An important and relevant disclosure regulation is the one contained in section 13(a) of the ICA. Section 13(a) prohibits registered investment companies (e.g., mutual funds) from making certain changes to their investment policies and practices without the prior approval of shareholders. 15 U.S.C. § 80a-13(a). As noted above, the centerpiece of Northstar's breach-of-contract theory is its allegation that Petitioners violated this statutory requirement. A persistent problem that Northstar has faced, however, is that section 13(a) does not authorize a private right of action, let alone a right of action sounding in contract. Indeed, in a prior decision in this very case, the Ninth Circuit flatly rejected

Northstar's assertion of a private cause of action under section 13(a) based on Petitioners' disclosures. *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 615 F.3d 1106 (9th Cir. 2010); Pet. App. 133a.

In an effort to circumvent this prohibition, Northstar attempted, and the Ninth Circuit has now endorsed, a re-packaging of the section 13(a) claim as a novel breach-of-contract theory. This unprecedented approach, however, is unworkable and otherwise entirely inconsistent with both the letter and spirit of the governing securities laws.[5]

To begin with, treating a prospectus as a contract in a setting such as this is inherently contrary to basic contract principles. A fundamental characteristic of a contract is bilateral agreement, but Federal regulations expressly permit funds to change or withdraw many aspects of a prospectus *unilaterally* at any time. *See* 17 C.F.R. §§ 230.485; 230.497.[6] Indeed, even

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[5] The Ninth Circuit notably relied principally upon the concurrence of Justice Story in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819) in holding that the Fund's mandatory SEC filings could form a contract between the Trust and individual shareholders, which, of course, was decided well over a century before Congress began comprehensively regulating nationally traded securities.

[6] For example, a fund can typically unilaterally change its investment strategies, the types of securities in

though the Fund here was required to seek shareholder ratification of changes to fundamental policies, the Fund could adopt additional fundamental policies at any time without shareholder approval. 15 U.S.C. § 80a-8(b)(3). The ability to unilaterally change and add matters to an undertaking is obviously contrary to the very idea of a contract. *See, e.g., Douglas v. United States District Court*, 495 F.3d 1062, 1066 (9th Cir. 2007) ("[A] party can't unilaterally change the terms of a contract.").

In addition, the SEC periodically changes what funds are required to disclose. Moreover, as noted, many disclosures involve changes funds have discretion to make in updating their investment strategies and objectives. These considerations are likewise antithetical to the idea of a contract.

Furthermore, the kind of "contract" the Ninth Circuit recognized here is untenable because it puts mutual funds in an impossible situation by pitting their obligation to comply with federal securities laws against the prospect of a common-law action for breach-of-contract as a consequence of their compliance. Among other

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which it invests and the extent to which they invest in such securities, fund investment and maintenance minimums, applicability and level of redemption fees and account fees, and purchase and redemption procedures. *See* 17 C.F.R. §§ 230.485; 230.497.

things, federal regulations *require* funds to update their registration statements at least annually, which frequently requires funds to make changes to these statements. *See* 17 C.F.R. §§ 230.485, 230.497. Additionally, the Securities Law Uniform Standards Act ("SLUSA") affirmatively encourages issuers to make forward-looking statements by providing a safe-harbor from private liability so long as the statements are accompanied by meaningful cautionary language identifying important risk factors. 15 U.S.C. § 77z-2. Yet, under the Ninth Circuit's novel approach, in which these mandatory disclosures may constitute "contracts," any subsequent event that renders a forward-looking statement incorrect, for example as a result of unforeseen changes in market conditions, may give rise to a common-law breach-of-contract claim. Thus, mutual funds would inevitably be subject to routine claims that they breached fund "contracts" when they update or modify their disclosures as required by federal law.

Apart from saddling mutual funds with a Hobson's Choice between compliance with federal securities laws and the prospect of a breach-of-contract suit, the Ninth Circuit's approach generates untoward results. Under the Ninth Circuit's theory, in which each disclosure is potentially a contract, funds are incentivized to provide *less* disclosure, rather than more. This is antithetical to the bedrock principles of the federal disclosure laws. Moreover, funds will now have thousands of individual contracts with different shareholders based on the disclosures in effect at the time each purchased their shares, often with different terms, otherwise frustrating the necessary, routine, and uniform function of these disclosures under federal law.

### B. The Ninth Circuit's Decision Impairs The Uniform Regulation Of Nationally Traded Securities In Conflict With Various Federal Laws Designed To Ensure Uniformity.

The Ninth Circuit's novel contract theory is antithetical to Congress's comprehensive efforts to achieve and protect the uniform, federal regulation of nationally traded securities, particularly with respect to disclosure requirements. Prior to the Ninth Circuit's decision in this case, mutual funds needed only to look to one set of law—federal law—to guide their disclosure obligations. Now, mutual funds must also pay attention to (and attempt to harmonize) the differing requirements and effects of as many common-law contract theories as the courts may recognize. But this disfiguring complexity is precisely what Congress has long sought to prevent through a series of legislative reforms. These reforms include not only those that limit state-court litigation based on common-law theories, but also more broadly the role of state law in the regulation of nationally traded securities. The Ninth Circuit's ruling that investors may establish a breach-of-contract claim where a fund has allegedly failed to adhere to the representations in its prospectus effectively sidesteps and conflicts with these laws.

To begin with, in 1996 Congress adopted the National Securities Market Improvement Act ("NSMIA"). The NSMIA largely preempts state "blue sky" laws relating to the registration of federal securities and the offering materials that accompany them. Specifically, the NSMIA states that "no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a [covered] security." 15 U.S.C. § 77r(a)(1).[7] Furthermore, state laws may not "directly or indirectly prohibit, limit, or impose any conditions upon the use of ... any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission ...." *Id.* at § 77r(a)(2). The NSMIA provides a narrow exception to its sweeping preemption of state

[7] Under federal law, investment company securities are "covered securities." *See id.* at § 77r(b)(2).

securities disclosure laws to permit the States to "retain jurisdiction ... to investigate and bring enforcement actions, in connection with securities or securities transactions with respect to fraud or deceit." *Id.* § 77r(c)(1). But in cases other than state regulatory investigations involving fraud or deceit, the sweep of the preemptive nature of the federal regime is clear. By permitting a litigant to pursue a common-law breach-of-contract claim based on a fund's mandatory SEC disclosures, the decision below clearly undermines and conflicts with the letter and spirit of the NSMIA.

Consistent with its goals in enacting the NSMIA, Congress has also sought to create national standards for securities enforcement and litigation by precluding state-court securities class actions based on state law through a series of statutory reforms. While Congress passed the original Securities Act of 1933 and the Securities Exchange Act of 1934 in response to various abuses associated with the stock market crash of 1929, by the mid-1990s, Congress recognized that the securities class-action device itself was "being used to injure 'the entire U.S. economy.'" *Dabit,* 547 U.S. at 81 (quoting H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.)). As this Court has explained, "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent' had become rampant," and "these abuses resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Id.* In response, Congress passed the Private Securities Litigation Reform Act (PSLRA) in 1995, which heightened the pleading standards for federal securities claims, in an attempt to correct these "perceived abuses of the class-action vehicle in litigation involving nationally traded securities." *Id.*

In an effort to avoid the restrictions of the PSLRA, some plaintiffs abandoned federal-law securities claims in favor of state-law claims brought in state court, including those targeting an issuer's disclosures. At the time, the SEC identified this shift to state-law claims in state court as "potentially the most significant development in securities litigation" since the passage of the PSLRA. H.R. Rep. No. 105-803, at 14 (1998) (internal quotations and citation omitted). In response, Congress enacted SLUSA, stating in the preamble that, although "the [PSLRA] sought to prevent abuses in private securities fraud lawsuits[,] … a number of securities class action lawsuits have shifted from Federal to State courts" and that this "shift has prevented that Act from fully achieving its objectives." Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, §§ 2(1)-(3). To remedy this problem, Congress explained that "it is appropriate to enact national standards for securities class action lawsuits ...." *Id.* §2(5).

SLUSA sought to achieve this goal primarily by precluding any "covered class action"—traditional class actions as well as non-traditional class actions in which damages are sought by more than fifty plaintiffs—brought under state law involving allegedly untrue statements or omissions made in connection with the purchase or sale of a security traded on a national exchange. 15 U.S.C. § 77p(b), (f). After SLUSA, securities class actions must now be brought under federal law. In addition, SLUSA withdrew state courts' jurisdiction over all covered class actions. *Id.* § 77v(a).

In the Joint Explanatory Statement of the Committee of Conference, which conference was convened to reconcile the Senate and House versions of SLUSA, the conferees stated that, through its broad preclusion of state-law based litigation over securities disclosures, SLUSA "establishes uniform national rules for securities class action litigation involving our national capital markets." H.R. Rep. No. 105-803, at 13. President Clinton also indicated that SLUSA was meant to impose uniform standards on the regulation of nationally traded securities and litigation over them. When signing SLUSA into law, he explained that "there has been considerable concern that the goals of the [PSLRA] have not been realized" because "State actions are being used to achieve an 'end run' around" the PSLRA. Presidential Statement on Signing the Securities Litigation Uniform Standards Act of 1998, 34 Weekly Comp. Pres. Doc. 45, at 2248 (Nov. 3, 1998). He emphasized that SLUSA was important to make federal securities laws more clear "[s]ince the uniform standards provided by this legislation" required that litigation involving federal securities "will be governed by Federal law ...." *Id.*

The Ninth Circuit's ruling that investors may establish a common-law breach-of-contract claim where a mutual fund has allegedly failed to adhere to the representations in its prospectus effectively permits the same "end-run" around the limitations of the federal securities laws that Congress sought to foreclose, and would inject chaos where uniformity is demanded. Because of the importance of the question, certiorari is warranted.

### C. The Decision Below Also Establishes An Unprecedented Theory That Is Inconsistent With The Decisions Of Other Courts And This Court's Precedents Declining To Recognize Common-Law Theories Of Liability In The Securities Area.

The decision below cites no prior case law supporting its novel theory of contract creation and enforcement based upon a fund's mandatory

SEC disclosures. In contrast, other courts have specifically declined to find contractual rights based on similar mandatory SEC filings. *See In re Intelogic Trace, Inc.*, No. 97-50932, 1999 WL 152944, at *2 (5th Cir. Feb. 22, 1999) (affirming dismissal of claims "[b]ecause the Prospectus was not a contract between the Bondholders and Intelogic"); *see also Lanier v. BATS Exchange, Inc.,* No. 14-cv-3745 (KBF), 2015 WL 1914446 (S.D.N.Y. April 28, 2015) (rejecting state-law breach of contract cause of action for alleged breach of agreements to provide timely quote and last sale data for covered securities to investors, because such agreements are comprehensively regulated under the federal securities laws and may not be enforced in a private state-law action alleging breach of contract), *appeal docketed*, No. 15-1693 (2d Cir. May 21, 2015). Recognizing Congress's sustained interest in regulating the national securities markets comprehensively, this Court has similarly rejected judicial attempts to create causes of action under the federal securities laws that Congress has not expressly prescribed. *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) ("The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute."); *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) ("[W]e must give 'narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" (quoting *Stoneridge Inv. Partners, LLC v. ScientificAtlanta, Inc.*, 552 U.S. 148, 167 (2008))).

Neither the ICA nor any other applicable federal law or regulation governing mandatory SEC disclosures authorize the novel breach-of-contract theory that the Ninth Circuit recognized in this case. In addition, neither the ICA nor any other applicable federal securities law or regulation produce any indicia of an intent to create contractual relationships between funds and their shareholders of the kind at issue here, let alone contracts that may support a private right of action. On the contrary, as noted, doing so would affirmatively contravene the letter and spirit of the existing regulatory scheme. In such an environment, the Ninth Circuit's recognition of Northstar's novel theory was particularly inappropriate. Certiorari is warranted.

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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July 27, 2015 *Counsel for Petitioners*

# Appendix

**APPENDIX A – OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT DECIDED APRIL 28, 2015**

**FOR PUBLICATION**

**UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT**

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|---|---|
| NORTHSTAR FINANCIAL ADVISORS INC, on behalf of itself and all others similarly situated, *Plaintiff-Appellant*,<br><br>v.<br><br>SCHWAB INVESTMENTS; MARIANN BYERWALTER, DONALD F. DORWARD, WILLIAM A. HASLER, ROBERT G. HOLMES, GERALD B. SMITH, DONALD R. STEPHENS, MICHAEL W. WILSEY, CHARLES R. SCHWAB, RANDALL W. MERK, JOSEPH H. WENDER and JOHN F. COGAN, as Trustees of Schwab Investments; and Charles Schwab Investment Management, Inc., *Defendants-Appellees*. | No. 11-17187<br><br>D.C. No. 5:08-cv-4119-LHK<br><br>ORDER AND AMENDED OPINION |

*Appendix A*

Appeal from the United States District Court
for the Northern District of California
Lucy H. Koh, District Judge, Presiding

Argued and Submitted
May 17, 2013—San Francisco, California

Filed March 9, 2015
Amended April 28, 2015

Before: Richard R. Clifton and Carlos T. Bea,
Circuit Judges, and Edward R. Korman, Senior
District Judge.*

Order;
Opinion by Judge Korman;
Dissent by Judge Bea

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**SUMMARY****

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**Mutual Funds**

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* The Honorable Edward R. Korman, Senior District Judge for the United States District Court for the Eastern District of New York, sitting by designation.

** This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

The panel reversed in part and vacated in part the district court's dismissal of a shareholder class action on behalf of investors who alleged that the managers of the Schwab Total Bond Market Fund, a mutual fund, failed to adhere to the Fund's fundamental investment objectives of seeking to track a particular index and not over-concentrating its investments in any one industry. The Fund was created by Schwab Investments ("Schwab Trust"), a "Massachusetts trust," and its investment adviser was Charles Schwab Investment Management, Inc. ("Schwab Advisor").

The named plaintiff was Northstar Financial Advisors, Inc., a registered investment advisery and financial planning firm that managed accounts on behalf of investors and had over 200,000 shares of the Fund under its management. The panel held that Northstar had standing because it filed a supplemental pleading under Federal Rule of Civil Procedure 15(d) after obtaining an assignment of claim from an investor in the Fund.

The panel reversed the district court's dismissal of breach of contract claims. It held that the Fund shareholders' adoption of the investment objectives added a structural restriction on the power conferred on the Fund trustees that could only be changed by a vote of the shareholders, and was subsequently reflected in the Fund's registration statements and prospectuses, and thus created a contract between the trustees and Fund investors.

Vacating the dismissal of fiduciary duty claims, the panel held that the operative complaint stated a claim that the Schwab defendants breached their fiduciary duties by failing to ensure that the Fund was managed in accordance with the fundamental investment objectives and by changing the Fund's fundamental investment objectives without obtaining required shareholder authorization. The panel held that the trustees owed a fiduciary duty to the shareholders, rather than the Fund, and so Northstar was not required to proceed by way of a derivative action.

The panel reversed the dismissal of a third-party beneficiary breach of contract claim. It held that Northstar adequately alleged that the investors were third-party beneficiaries of the Investment Advisory and Administration Agreement between Schwab Trust and Schwab Advisor.

The panel declined to address the effect of the Securities Litigation Uniform Standards Act on the various common law causes of action. It remanded the case to the district court.

Dissenting, Judge Bea wrote that Northstar lacked standing because, at the commencement of the action, it did not own any fund shares, nor did it own any claims of others who had suffered losses the defendants had allegedly caused.

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## COUNSEL

Robert C. Finkel (argued), Wolf Popper LLP, New York, New York; Joseph J. Tabacco, Jr., Christopher T. Heffelinger, and Anthony D. Phillips, Berman DeValerio, San Francisco, California; Marc J. Gross, Greenbaum Rowe Smith & Davis LLP, Roseland, New Jersey, for Plaintiff-Appellant.

Karin Kramer and Arthur M. Roberts, Quinn Emanuel Urquhart & Sullivan, LLP, San Francisco, California; Richard Schirtzer (argued), Susan R. Estrich, and B. Dylan Proctor, Quinn Emanuel Urquhart & Sullivan, LLP, Los Angeles, California, for Defendants-Appellees.

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## ORDER

Judge Clifton and Judge Korman voted to deny the petition for rehearing. Judge Bea voted to grant the petition. The petition for rehearing is **DENIED**.

The full court has been advised of the petition for rehearing en banc and no judge of the court has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35. The petition for rehearing en banc, filed March 23, 2015, is **DENIED**.

The opinion filed March 9, 2015 is amended. The sentence beginning immediately after the quote at the top of page 53 currently reads as follows:

> Indeed, notwithstanding the requirement that a percentage of the members of the mutual fund board be "independent" from the adviser, Congress required that the shareholders of the Fund annually approve the adviser contract. 15 U.S.C. § 80a-15.

The sentence is amended to read as follows:

> Indeed, notwithstanding the requirement that 40 percent of the members of the mutual fund board be "independent" from the adviser, 15 U.S.C. § 80a-10(a), Congress required that the shareholders of the Fund approve the initial contract for any adviser. 15 U.S.C. § 80a-15.

No further petitions for rehearing following this amendment may be filed.

## OPINION

KORMAN, District Judge:

The Investment Company Act ("ICA") establishes a comprehensive federal regulatory framework applicable to mutual funds. *See* 15 U.S.C. § 80a-1 *et seq*. More specifically, it provides that a mutual fund's registration statement must recite all investment policies that can be changed only by shareholder vote. 15 U.S.C. § 80a-8(b). Deviation from policies so designated violates § 13(a) of the ICA. 15 U.S.C. § 80a-13(a)(3). This appeal arises out of a class action on behalf of investors who allege that the managers of the Schwab Total Bond Market Fund ("Fund") failed to adhere to two of the Fund's fundamental investment objectives; namely, that it seek to track a particular index and that it not over-concentrate its investments in any one industry. These objectives, which could only be changed by a vote of the shareholders, were adopted by a shareholder vote and subsequently incorporated in the Fund's registration statement and prospectuses.

On a previous interlocutory appeal, we rejected the argument that this conduct gave rise to an implied private right to enforce § 13(a) of the ICA. *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 615 F.3d 1106 (9th Cir. 2010). On this appeal from an order granting a motion to dismiss a Third Amended Complaint, the principal issues are whether the investors have stated valid causes of action for breach of contract, breach of fiduciary duty, and breach of an agreement to which the investors claim to be third-party beneficiaries.

## BACKGROUND

Schwab Investments ("Schwab Trust") is an investment trust organized under Massachusetts law. Such a trust, which is often referred to generically as a "Massachusetts trust," even when not created under Massachusetts law, is an unincorporated business organization created by an instrument of trust by which property is to be held and managed by trustees for the benefit of persons who are or become the holders of the beneficial interests in the trust estate. *See Hecht v. Malley*, 265 U.S. 144, 146–47 (1924).[1] Thus, the Schwab Trust's Agreement and Declaration of Trust states that "the Trustees hereby declare

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1 "Unlike the corporation of the late 1800s and early 1900s, the common law business trust was only lightly regulated, so entrepreneurs used the business trust to escape the comparatively much heavier regulation of the corporate form. Using the business trust for this purpose was so pronounced in Massachusetts, where corporate ownership of real estate was prohibited, that the term *Massachusetts trust* became synonymous with business trust." Jesse Dukeminier, Robert H. Sitkoff & James Lindgren, *Wills, Trusts, and Estates* 555–56 (8th ed. 2009).

that they will hold all cash, securities and other assets, which they may from time to time acquire in any manner as Trustees hereunder IN TRUST to manage and dispose of the same . . . for the pro rata benefit of the holders from time to time of Shares in this Trust." Schwab Investments, Registration Statement (Form N-1A), Agreement and Declaration of Trust 1 (Ex. 1) (Dec. 29, 1997) [hereinafter "Agreement and Declaration of Trust"]. Such a "trust today is a preferred form of organization for mutual funds and asset securitization." Dukeminier, Sitkoff & Lindgren, *Wills, Trusts, and Estates* 556.

One of the significant features that distinguishes a Massachusetts trust from the ordinary or private trust "lies in the manner in which the trust relationship is created; investors in a business trust enter into a voluntary, consensual, and contractual relationship, whereas the beneficiaries of a traditional private trust take their interests by gift from the donor or settlor." Herbert B. Chermside, Jr., *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704, 720 (1978); *see also Berry v. McCourt*, 204 N.E.2d 235, 240 (Ohio Ct. App. 1965) ("By an underlying contract, or in the provisions of a business trust instrument, or both, the parties agree on the operations of the venture."). Thus, the Agreement and Declaration of Trust at issue here states at the very outset that it was made "by the Trustees hereunder, and by the holders of shares of beneficial interest to be issued hereunder." Agreement and Declaration of Trust 1. Moreover, it continues that "[e]very Shareholder by virtue of having become a Shareholder shall be held to have expressly assented and agreed to the terms hereof and to have become a party hereto." Agreement and Declaration of Trust 4.

Because this case involves the relationship between investors and a mutual fund, the trust which created the fund and the investment adviser which manages the fund, it is helpful to have a clear understanding of the relationships among these parties. We begin with a useful, if oversimplified, description of a mutual fund:

> *T*, an investment professional, approaches *A, B, C*, and others like them and agrees to pool certain of their assets in a common fund to be managed by *T. A, B, C*, and the other investors each receive tradable shares in the fund in an amount proportional to their investment. By structuring their collective investment in this way, *A, B, C*, and the others are able to take advantage of economies of scale, obtain professional portfolio management, and achieve a more diversified portfolio than each could have individually. In managing the portfolio, *T* is subject to a fiduciary

> obligation to *A, B, C*, and the other investors in the fund.

Dukeminier, Sitkoff & Lindgren, *Wills, Trusts, and Estates* 556.

This simple description does not adequately discuss perhaps the most important party to this arrangement, namely, the investment adviser, whose "main role is to supervise and manage the fund's assets, including handling the fund's portfolio transactions." Clifford E. Kirsch, *An Introduction to Mutual Funds, in Mutual Fund Regulation §* 1:2.2 (Clifford E. Kirsch ed., 2d ed. 2005). The investment adviser is not a mere employee, contractor, or consultant. Instead, it is "more often than not also the creator, sponsor, and promoter of the mutual fund." Charles E. Rounds, Jr. & Charles E. Rounds, III, *Loring and Rounds: A Trustee's Handbook* 955–56 (2012 ed.); *see also Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 93 (1991) (Mutual funds "typically are organized and underwritten by the same firm that serves as the company's 'investment adviser.'"); *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (Mutual funds are "typically created and managed by a pre-existing external organization known as an investment adviser." (citing *Burks v. Lasker*, 441 U.S. 471, 481 (1979))).

Thus, while "[i]n theory, the [trust] is able to choose any adviser it deems appropriate to invest the fund's portfolio, based on the adviser's investing style, track record and fees," in practice, the investment adviser picked to manage the portfolio is most often self-selected and unlikely to be removed. John Shipman, *So Who Owns Your Mutual Fund?*, Wall St. J., May 5, 2003, at R1, *available at* http://online.wsj.com/news/articles/SB105207969873142900. Because "a typical fund is organized by its investment adviser which provides it with almost all management services . . . , a mutual fund cannot, as a practical matter sever its relationship with the adviser." *Burks*, 441 U.S. at 481 (quoting S. Rep. No. 91-184, at 5 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901).

Consistent with this description of the structure of a mutual fund and its relationship with its investment adviser, the Schwab Trust selected Charles Schwab Investment Management, Inc. ("Schwab Advisor") as its investment adviser. Indeed, Charles R. Schwab is alleged to have been chairman and trustee of the Schwab Trust and a member of the board of the Schwab Advisor. Third Am. Compl. ¶ 38. The latter is a subsidiary of the Charles Schwab Corporation, of which Mr. Schwab has served as "CEO at various times, including from 2004 through October 2008." Third Am. Compl. ¶ 36. Moreover, the complaint alleges that all "[d]efendants and their affiliates held themselves out as one Schwab entity[.]" Third Am. Compl. ¶ 167.

The mutual fund at issue here, one of several operated by the Schwab Trust, is the Schwab Total Bond Market Fund. Reflecting the terms of a proxy statement proposed by the Schwab Trust in 1997, and subsequently adopted by the shareholders by majority vote, the prospectuses that the Fund issued during the relevant period stated that the Fund was "designed to offer high current income by tracking the performance of the Lehman Brothers [U.S.] Aggregate Bond Index [("Lehman Index")]" and was "intended for investors seeking to fill the fixed income component of their asset allocation plan." Specifically, the Lehman Index included "investment-grade government, corporate, mortgage-, commercial mortgage- and asset-backed bonds that [were] denominated in U.S. dollars and ha[d] maturities longer than one year." *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 609 F. Supp. 2d 938, 945 (N.D. Cal. 2009).[2] Nevertheless, the Fund is not itself an index fund and, according to the Fund's prospectus, it was "not required to invest any percentage of its

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[2] The former Lehman Index is now known as the Barclays U.S. Aggregate Bond Index. It currently "comprises a total of 8,286 bonds and is worth nearly $17 trillion." Carolyn Cui, *Barclays Agg Had Modest Origin*, Wall St. J., Apr. 2, 2013, http://online.wsj.com/article/SB10001424127887324883604578398880679949670.html. "[A]bout $663 billion of institutional assets is invested in 270 U.S. core fixed-income portfolios, 75% of which are benchmarked against the Barclays Agg Index." *Id.*

assets in the securities represented in the [Lehman] Index." Decl. of Kevin Calia in Support of Motion to Dismiss Second Amended Class Action Complaint, Ex. A at 14, Nov. 10, 2010.

The Fund disclosed in its registration statement, and reiterated in prospectuses issued thereafter, that its policy of tracking the Lehman Index was "fundamental," which means that it "cannot be changed without approval of the holders of a majority of the outstanding voting securities (as defined in the [ICA])." Schwab Investments, Registration Statement 5, 14 (Form N-1A) (Jan. 16, 1998), Prospectus 10 (Form N-1A, Part A) (Nov. 1, 1997, as amended Jan. 15, 1998); *see also* Michael Glazer, *Prospectus Disclosure and Delivery Requirements, in Mutual Fund Regulation* § 4:3.6 (Clifford E. Kirsch ed., 2d ed. 2005). The Fund was also precluded from investing twenty-five percent or more of the Fund's total assets in any one industry, unless necessary to track the Lehman Index. Schwab Investments, Registration Statement 41 (Form N-1A) (Jan. 16, 1998), Statement of Additional Information 11 (Form N-1A, Part B) (Nov. 1, 1997, as amended Jan. 15, 1998).

Northstar Financial Advisors, Inc. ("Northstar") is a registered investment advisery and financial planning firm that manages discretionary and non-discretionary 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 against the defendants, alleging that they deviated from the Fund's fundamental investment policies and exposed the Fund and its shareholders to tens of millions of dollars in losses.

Northstar has identified two classes of potential plaintiffs: (1) a "Pre-Breach" class, consisting of those who purchased shares of the Fund on or prior to August 31, 2007, and who continued to hold their shares as of August 31, 2007, and (2) a "Breach" class, consisting of those who purchased shares of the Fund during the period September 1, 2007 through February 27, 2009. Northstar alleges that August 31, 2007 was the last day of the fiscal year preceding the one during which the Fund first began deviating from its required fundamental investment policies, and that on February 27, 2009, the Fund reverted back to the required policies.

This case has a lengthy and complicated procedural history that includes the dismissal of successive amended complaints for failure to state a cognizable cause of action. Specifically, the Third Amended Complaint, which is based on the Fund's unauthorized deviation from its fundamental investment objectives, alleges five causes of action on behalf of each of the two identified classes, for a total of ten claims:

breach of fiduciary duty against the Trustees[3] (counts one and six); breach of fiduciary duty against Schwab Advisor (counts two and seven); aiding and abetting breach of fiduciary duty against the Trustees (counts three and eight); aiding and abetting breach of fiduciary duty against Schwab Advisor (counts four and nine); breach of the Investment Advisory and Administration Agreement ("IAA") between Schwab Trust and Schwab Advisor. The last cause of action is based on the allegations that the investors are third-party beneficiaries of the IAA. The Third Amended Complaint also incorporates by reference a breach of contract cause of action against the Schwab Trust that was alleged in the Second Amended Complaint, but dismissed with prejudice on an earlier motion to dismiss. The incorporation by reference was included to preserve Northstar's right to appeal from the dismissal of this cause of action with prejudice.

## STANDARD OF REVIEW

We review de novo the district judge's order granting a motion to dismiss. *Manzarek v. St.*

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3 "Trustees" is a collective reference to the trustees of Schwab Trust: defendants Mariann Byerwalter, Donald F. Dorward, William A. Hasler, Robert G. Holmes, Gerald B. Smith, Donald R. Stephens, Michael W. Wilsey, Charles R. Schwab, Randall W. Merk, Joseph H. Wender, and John F. Cogan.

*Paul Fire & Marine Ins. Co.*, 519 F.3d 1025, 1030 (9th Cir. 2008). On a motion to dismiss, "[w]e accept factual allegations in the complaint as true and construe the pleadings in the light most favorable to the non-moving party." *Id.* at 1031. "[W]e may consider materials incorporated into the complaint or matters of public record." *Coto Settlement v. Eisenberg*, 593 F.3d 1031, 1038 (9th Cir. 2010). We may also consider "documents 'whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the [plaintiff's] pleading.'" *Knievel v. ESPN*, 393 F.3d 1068, 1076 (9th Cir. 2005) (alteration in original) (quoting *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir. 1999)); *see also Ecological Rights Found. v. Pac. Gas & Elec. Co.*, 713 F.3d 502, 511 (9th Cir. 2013). This is sometimes referred to as the "incorporation by reference" doctrine. *Knievel*, 393 F.3d at 1076; *see also Lapidus v. Hecht*, 232 F.3d 679, 682 (9th Cir. 2000).

Among the documents we consider pursuant to that doctrine are three sets of the Schwab Trust's filings with the Securities and Exchange Commission: (1) the Registration Statement of December 29, 1997; (2) the Registration Statement of January 16, 1998, which was filed with the Prospectus and Statement of Additional Information of November 1, 1997, as amended January 15, 1998; and (3) the Prospectus and Statement of Additional Information of November 15, 2004. While all of these documents are referred to in the complaint, the entire content of each document does not appear to be part of the record. Nevertheless, "[i]t is appropriate to take judicial notice of this information, as it was made publicly available by [the SEC], and neither party disputes the authenticity of the [documents] or the accuracy of the information displayed therein." *Daniels-Hall v. Nat'l Educ. Ass'n*, 629 F.3d 992, 998–99 (9th Cir. 2010) (citing Fed. R. Evid. 201); see also Dreiling v. Am. Express Co., 458 F.3d 942, 946 n.2 (9th Cir. 2006) (We "may consider documents referred to in the complaint or any matter subject to judicial notice, such as SEC filings."). Indeed, defendants, who might otherwise be aggrieved by their use, created and filed them with the SEC. Under these circumstances, it is appropriate for us to consider them here. See 1 Christopher B. Mueller & Laird C. Kirkpatrick, Federal Evidence § 2:8 at 359–61 (4th ed. 2013).

## DISCUSSION

### *I. Standing*

We pause before addressing the merits to discuss the issue of whether Northstar has standing. Northstar filed its initial class action complaint on behalf of investors in the Fund on August 28, 2008. Northstar owned no shares of the Fund, but it brought the action in its own name, without obtaining an assignment of claims from an investor in the Fund. Subsequently, in a comparable case brought by an asset management firm, the Second Circuit held that "the minimum requirement for injury-in-fact is that the plaintiff have legal title to, or a proprietary interest in, the claim." *W.R. Huff Asset Mgmt. Co. v. Deloitte & Touche LLP*, 549 F.3d 100, 108 (2d Cir. 2008). On December 8, 2008, after W.R. Huff was decided, Northstar obtained an assignment of claim from a client-shareholder.

Defendants argue that because standing must be determined at the time a complaint is filed, and because Northstar did not obtain an assignment of claim until several months after the original complaint was filed, the assignment could not cure Northstar's original lack of standing. The district judge (Susan Illston, *J.*), to whom the case was then assigned, dismissed Northstar's complaint for lack of standing with a suggestion that this defect could be cured by filing an amended complaint. *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 609 F. Supp. 2d 938, 942 (N.D. Cal. 2009). Northstar followed her suggestion. After Schwab renewed its motion to dismiss the amended complaint, the district court judge to whom the case had been reassigned (Lucy Koh, *J.*) declined to order the dismissal of the complaint because to do so would have "elevate[d] form over substance" and thus she treated the prior order as granting plaintiff leave to file a supplemental pleading under Rule 15(d) instead of an amended complaint pursuant to Rule 15(a). *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 781 F. Supp. 2d 926, 932–33 (N.D. Cal. 2011). In so doing, she observed that, "[a]lthough there is no published Ninth Circuit authority on this point, courts in other circuits have found that parties may cure standing deficiencies through supplemental pleadings." *Id.* at 933 (citing, *inter alia*, *Travelers Ins. Co. v. 633 Third Assoc.*, 973 F.2d 82, 87–88 (2d Cir. 1992)). We review this ruling *de novo, Renee v. Duncan*, 686 F.3d 1002, 1010 (9th Cir. 2012), and we agree with Judge Koh's application of Fed. R. Civ. P. 15(d).

Rule 15(d) permits a supplemental pleading to correct a defective complaint and circumvents "the needless formality and expense of instituting a new action when events occurring after the original filing indicated a right to relief." Wright, Miller, & Kane, Federal Practice and Procedure: Civil 3d § 1505, pgs. 262–63. Moreover, "[e]ven though [Rule 15(d)] is phrased in terms of correcting a deficient statement of 'claim' or a 'defense,' a lack of subject-matter jurisdiction should be treated like any other defect for purposes of defining the proper scope of supplemental pleading." *Id.* at § 1507, pg. 273. Indeed, in *Matthews v. Diaz*, 426 U.S. 67 (1976), the Supreme Court addressed the issue in a case in which an applicant for Medicare had failed to file his application until after an amended complaint had been filed joining him as an additional complainant in an as-yet uncertified class action. In holding that this jurisdictional defect could be cured by a supplemental pleading, the Supreme Court observed:

> Although 42 U.S.C. § 405(g) establishes filing of an application as a nonwaivable condition of jurisdiction, Espinosa satisfied this condition while the case was pending in the District Court. A supplemental complaint in the District Court would have eliminated this jurisdictional issue; since the record discloses, both by affidavit and stipulation, that the jurisdictional condition was satisfied, it is not too late, even now, to supplement the complaint to allege this fact.

*Id.* at 75 (internal citations omitted). This holding is consistent with *Rockwell Int'l Corp. v. United States*, in which the Supreme Court subsequently held that "when a plaintiff files a complaint in federal court and then voluntarily amends the complaint, courts look to the amended complaint to determine jurisdiction." 549 U.S. 457, 473–74 (2007).

We add here a brief discussion of the thoughtful holding of the Court of Appeals for the Federal Circuit that summarizes the case law addressing supplemental pleadings. There, "[a]s an initial matter, the parties dispute[d] whether the allegations in [the plaintiff's] Amended Complaint that concern actions taken after the filing of the initial complaint can be used to establish subject matter jurisdiction." *Prasco, LLC v. Medicis Pharm. Corp.*, 537 F.3d 1329, 1337 (Fed. Cir. 2008). Relying on Rule 15(d) and *Matthews v. Diaz*, the Court of Appeals treated the complaint as a supplemental complaint and held that it was sufficient to cure the original complaint's jurisdictional defect:

> Thus, while "[l]ater events may not create jurisdiction where none existed at the time of filing," the proper focus in determining jurisdiction are "the facts existing at the time the complaint *under consideration* was filed." *GAF Bldg. Materials Corp. v. Elk Corp.*, 90 F.3d 479, 483 (Fed.Cir.1996) (emphasis added) (quoting *Arrowhead Indus. Water, Inc. v. Ecolochem Inc.*, 846 F.2d 731, 734 n. 2 (Fed. Cir. 1988)); *see also Rockwell Int'l Corp. v. United States*, 549 U.S. 457, 127 S.Ct. 1397, 1409, 167 L.Ed.2d 190 (2007) ("[W]hen a plaintiff files a complaint in federal court and then voluntarily amends the complaint, courts look to the amended complaint to determine jurisdiction."); *Connectu LLC v. Zuckerberg*, 522 F.3d 82 (1st Cir.

> 2008). As the district court accepted Prasco's Amended Complaint, it is the Amended Complaint that is currently under consideration, and it is the facts alleged in this complaint that form the basis for our review.

*Id. See also Feldman v. Law Enforcement Assocs. Corp.*, 752 F.3d 339, 347 (4th Cir. 2014) ("[W]e construe the present complaint as a supplemental pleading under Rule 15(d), thereby curing the defect which otherwise would have deprived the district court of jurisdiction under Rule 15(c)."); *Black v. Sec'y of Health and Human Servs.*, 93 F.3d 781, 790 (Fed. Cir. 1996) ("Nonetheless, a defect in the plaintiff's case, even a jurisdiction defect, can be cured by a supplemental pleading under Rule 15(d) in appropriate circumstances."); *United Partition Sys., Inc. v. United States*, 59 Fed. Cl. 627, 644 (Fed. Cl. 2004) ("The Supreme Court has interpreted Fed. R. Civ. P. 15(d) to permit supplemental pleadings in which a plaintiff may correct a jurisdictional defect in its complaint by informing the court of post-complaint events.").

Judge Koh's holding is also consistent with the approach to the Federal Rules of Civil Procedure taken by Judge Clark, "the principal architect of the Federal Rules of Civil Procedure." *Zahn v. International Paper Co.*, 414 U.S. 291, 297 (1973). Thus, in *Hackner v. Guaranty Trust Co. of New York*, 117 F.2d 95 (2d Cir. 1941), the complaint was subject to dismissal because the plaintiffs did not allege damages sufficient to satisfy the minimum amount required to invoke subject-matter jurisdiction on the basis of diversity of citizenship. An amended complaint was then filed which added a plaintiff, Eunice Eastman, whose alleged damages were "well over the requirement." *Id*. at 98. Speaking for the Second Circuit, Judge Clark wrote that subject-matter jurisdiction was proper notwithstanding the fact that it was first established by the addition of Eastman as a plaintiff in the amended complaint:

> Since [Eastman] alleges grounds of suit in the federal court, the only question is whether or not she must begin a new suit again by herself. Defendants' claim that one cannot amend a nonexistent action is purely formal, in the light of the wide and flexible content given to the concept of action under the new rules. Actually she has a claim for relief, an action in that sense; as the Supreme Court has pointed out, there is no particular magic in the way it is instituted. So long as a defendant has had service reasonably calculated to give him actual notice of the proceedings, the requirements of due process are satisfied. Hence no formidable obstacle to a continuance

> of the suit appears here, whether the matter is treated as one of amendment or of power of the court to add or substitute parties, Federal Rule 21, or of commencement of a new action by filing a complaint with the clerk, Rule 3. In any event we think this action can continue with respect to Eastman without the delay and expense of a new suit, which at long last will merely bring the parties to the point where they now are.

*Id.* (quotations and citations omitted); *see also* Fed. R. Civ. P. 1 (which provides that the Rules of Civil Procedure "should be construed and administered to secure the just, speedy, and inexpensive determination of every action and proceeding").

Our dissenting colleague relies on *Morongo Band of Mission Indians v. California State Board of Equalization*, 858 F.2d 1376 (9th Cir. 1988), for the proposition that "where the district court does not have subject matter jurisdiction over a matter at the time of filing, subsequent events do not confer subject matter jurisdiction on the district court." Dissent at 67–68. We find this argument inapposite because, unlike the present case, *Morongo* did not involve a supplemental pleading, much less one with allegations of events that occurred after the commencement of the action.

While *Morongo* does contain the broad statement that "subject matter jurisdiction must exist as of the time the action is commenced" and that a lack of subject-matter jurisdiction at the outset cannot be cured subsequently, it is now clear, if it was not then, that this rule is more nuanced than the inflexibility suggested by its language—both as it relates to curing jurisdictional defects through supplemental pleadings, *see, e.g., Matthews*, 426 U.S. 67, and other circumstances in which defects in subject-matter jurisdiction were cured by the substitution, addition, or elimination of a party, *see, e.g. Newman-Green, Inc. v. Alfonzo-Larrain*, 490 U.S. 826, 830 (1989); *Mullaney v. Anderson*, 342 U.S. 415 (1952); *California Credit Union League v. City of Anaheim*, 190 F.3d 997, 1000 (9th Cir. 1999). Nevertheless, we need not belabor this issue because, in order to decide this case, it is enough to say that the rule as stated in *Morongo* does not extend to supplemental pleadings filed pursuant to Fed. R. Civ. P. 15(d).

The same is true of *Righthaven LLC v. Hoehn*, 716 F.3d 1166 (9th Cir. 2013), which the dissent relies on for the "general principle that 'jurisdiction is based on facts that exist at the time of filing.'" Dissent at 67. Of course, a general principle, which *Righthaven* observed was subject to at least a few exceptions, is significantly different from the hard and fast rule that the language in *Morongo* suggested. Indeed, *Righthaven* acknowledged the possibility of additional exceptions and left open the question of whether "permitting standing based on a property interest acquired after filing" should be added to the list of exceptions. *Righthaven*, 716 F.3d at 1171 ("We need not decide whether the circumstances of this case call for a new exception to the general rule, however, because Righthaven lacked standing either way.").

Nor does the Supreme Court's holding in *Grupo Dataflux v. Atlas Global Group, L.P.*, 541 U.S. 567 (2004), compel a contrary result. There, diversity jurisdiction was lacking at the time the lawsuit was commenced because the plaintiff was a Texas-based limited partnership that included two Mexican citizens as members and the defendant was a Mexican corporation. *Id.* at 569. After a verdict was rendered in favor of the plaintiff, the district court granted the defendant's motion to dismiss for lack of jurisdiction. *Id.* On appeal, the plaintiff partnership argued that the Mexican partners had left the partnership in a transaction consummated the month before the trial began. *Id.* A sharply divided Supreme Court held that this change in the composition in the membership of the partnership was insufficient to cure the initial jurisdictional defect. Specifically, it held that the time-of-filing rule "measures all challenges to subject-matter jurisdiction premised upon diversity of citizenship against the state of facts that existed at the time of filing—whether the challenge be brought shortly after filing, after trial, or even for the first time on appeal." *Id.* at 571. Moreover, notwithstanding significant departures from the time-of-filing rule in diversity cases where the parties have changed after the filing of the complaint or on appeal, *see Newman-Green*, 490 U.S. at 830, it declined to depart from this rule where the post-filing change in circumstances "arose not from a change in the parties to the action, but from the change in the citizenship of a continuing party." *Grupo Dataflux*, 541 U.S. at 575 (citing *Conolly v. Taylor*, 27 U.S. 556 (1829)).

Nevertheless, we do not regard that holding as dispositive here. First, the present case does not involve the issue of diversity jurisdiction. *See Connectu LLC v. Zuckerberg*, 522 F.3d 82, 92 (1st Cir. 2008) ("While the Court [in *Grupo Dataflux*] relied upon the time-of-filing rule to thwart an effort to manufacture diversity jurisdiction during the pendency of an action, the decision operates exclusively in the realm of diversity jurisdiction."). More significantly, unlike *Grupo Dataflux*, the present case involves the filing of a supplemental pleading that became the operative pleading in the case on which subject-matter jurisdiction must be based.

Nor we do not see any consideration of policy that would justify a rule, for which our dissenting colleague argues, that a party such as

Northstar must file a new complaint instead of a supplemental pleading because of a post-complaint assignment from a party that had standing. The dissent does not dispute, nor can it, that the assignee of a cause of action stands in the shoes of the assignor, *Hoffeld v. United States*, 186 U.S. 273, 276 (1902), and unquestionably has the same standing to file a complaint that the assignor could have filed. *Sprint Communications Co. v. APCC Services*, 554 U.S. 269, 271 (2008). Indeed, the dissent concedes that "had Northstar accepted the dismissal without prejudice and then filed a new complaint *after* it obtained an assignment of rights, it would have had standing and a personal stake in the outcome of this litigation." Dissent at 65 n.5 (emphasis in original).

A rule that would turn on the label attached to a pleading is difficult for us to accept. As the Eleventh Circuit has observed in a case in which an amended complaint contained jurisdictional allegations that were based on post-complaint events, "[e]xcept for the technical distinction between filing a new complaint and filing an amended complaint, the case would have been properly filed. . . . We therefore hold that we have jurisdiction over this appeal and we will reach the merits." *M.G.B. Homes, Inc. v. Ameron Homes, Inc.*, 903 F.2d 1486 (11th Cir. 1990).

Perhaps reflecting sensitivity to having a case turn on the technical distinction between a new complaint and a supplemental pleading, the dissent suggests a policy reason for the hypertechnical rule it advocates. Thus, it argues that permitting a plaintiff to proceed by supplemental pleading alleging a post-complaint assignment of the claim has adverse practical effects. Dissent at 70. More specifically, "[u]ninjured parties, particularly those in search of class action lead plaintiff status, could sue first, then trawl for those truly and timely injured. Today the majority green-lights those who would race to the courthouse and bend Federal Rules of Civil Procedure and Article III standing requirements to gain an edge over other claimants who are not as fleet of foot." *Id.*

Under current law, however, the benefit that the dissent suggests goes to the winner of the race to the courthouse does not exist. Presumably, the dissent is referring to the fact that counsel for the lead plaintiff becomes class counsel. In 2003, however, Congress amended Fed. R. Civ. P. 23 to set out discrete standards for the appointment of class counsel. Thus, Rule 23(g) now provides that in appointing class counsel, courts should consider: the work counsel has done in identifying claims, counsel's experience in such matters, counsel's knowledge of the applicable law, and the resources that counsel will commit to representation. Fed. R. Civ. P. 23(g)(1)(A); Wright, Miller, & Kane, Federal Practice and Procedure: Civil 3d §

1802.3, pgs. 322–24.[4] Under these circumstances, it would be an abuse of discretion to appoint an attorney as class counsel solely because he may have won the race to the courthouse.

More significantly, the present case was not one in which Northstar won a race to the courthouse and in which its attorneys were appointed lead counsel for that reason. Indeed, by the time it obtained the assignment from Henry Holz, over three months had passed since the complaint was filed. This was more than enough time for a competing plaintiff to file a complaint. No such complaint was filed. In sum, whatever merit there may be to the dissent's concern, it is not present in this case and has been substantially eliminated by the 2003 amendments to the Federal Rules of Civil Procedure. Moreover, that a supplemental pleading can only be filed with the permission of the district judge provides additional protection against the misuse of the pleading for strategic gamesmanship.

Thus, we agree that Judge Koh did not abuse her discretion in permitting Northstar to file a

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4 Eight years before the amendment to Rule 23, although in a different way, Congress eliminated the race to the courthouse in securities class actions when it enacted the Private Litigation Securities Reform Act of 1995 (PLSRA). 15 U.S.C. § 77z-1(a)(3)(B)(iii); 15 U.S.C. § 78u-4(a)(3)(B)(iii).

supplemental pleading after a post-complaint assignment from a party that clearly had standing. *See Northstar*, 781 F. Supp. 2d at 931–33.

## *II. Merits*

Before we review each of Northstar's claims, we give a brief overview of the case, and explain how the various claims relate to each other. We begin with the various governing documents of the Fund to which we have already made reference. The Agreement and Declaration of Trust, and its bylaws, establish the Trust and govern its internal affairs, and are governed by Massachusetts law. The Fund's prospectus is issued by the Schwab Advisor on behalf of the Fund on an annual basis. The Statement of Additional Information, or "SAI," produced at the same time as the prospectus, is made available to investors freely on demand, although it does not need to be mailed to them automatically. *See* Glazer, *Prospectus Disclosure and Delivery Requirements, in Mutual Fund Regulation* § 4:3.2 (citing Sec. & Exch. Comm'n, Form N-1A at 7, *available at* http://www.sec.gov/about/forms/formn-1a.pdf (last visited Aug. 29, 2014)).

In 1997, a proxy statement was submitted to and approved by the Fund's investors. It included two relevant proposals which we have already described in detail. Briefly, Proposal 2 stated that the Trust would "seek[] to track the investment results of [the Lehman Index] through the use of an indexing strategy." Proposal 3 stated that the Trust would not invest more than 25% of the Fund's total assets in any industry. These fundamental investment objectives could be changed only by shareholder vote. Subsequent registration statements and prospectuses reflected these changes.

Northstar's original complaint alleged four causes of action arising from the Fund's alleged violations of the fundamental investment policies. First, Northstar claimed a private right of action under Section 13(a) of the Investment Company Act. Second, Northstar alleged that all of the defendants had breached their fiduciary duties to the shareholders. Third, Northstar claimed that all of the defendants had breached the contract between the investors and the Fund, contained in the Fund's prospectuses and its 1997 proxy statement. Finally, Northstar claimed that all of the defendants had violated the implied covenant of good faith and fair dealing.

On an interlocutory appeal, we rejected Northstar's theory that it had a private right of action under the Investment Company Act. *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 615 F.3d 1106 (9th Cir. 2010). Nevertheless, the district judge had allowed Northstar to replead its state law claims, specifying under which state's law they were asserted and on which documents they relied. *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 609 F. Supp. 2d 938, 945 (N.D. Cal. 2009).

Northstar then filed an amended complaint that left those claims at risk of dismissal under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), 15 U.S.C. §§ 77p, 78bb, because it contained allegations that suggested that its claims were based on misrepresentations. SLUSA bars certain state law class actions that allege "an untrue statement or omission of a material fact [or] the use[] of any manipulative or deceptive device or contrivance,"[5] 15 U.S.C. § 77p(b), unless the governing law is the law of the state that has chartered or organized the entity issuing the securities. *Id.* § 77p(d)(1).

SLUSA operates "wherever deceptive statements or conduct form the gravamen or essence of the claim." *Freeman Invs., LP v. Pac.*

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[5] The misrepresentation must also be "in connection with the purchase or sale of a covered security." There is no question that this class action is "in connection with the purchase or sale" of a covered security, and the district judge properly so concluded. *Northstar*, 781 F. Supp. 2d at 937; *see Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 86–87 (2006). As noted above, SLUSA does not apply if the action is brought under the law of the state of the organizing entity. 15 U.S.C. § 77p(d).

*Life Ins. Co.,* 704 F.3d 1110, 1115 (9th Cir. 2013). The district judge ruled that the "central theme" of the Second Amended Complaint was that the "defendants made misrepresentations about how investments in the Fund would be managed." *Northstar*, 781 F. Supp. 2d at 934. In the district judge's view, the crux of Northstar's case was that the defendants' statements about how the shareholders' funds would be managed were false, or became false when the Fund deviated from the index in 2007. *Id.* at 933–36. The district judge also noted that the Second Amended Complaint contained one specific allegation that the Trust gave a false explanation for why the Fund underperformed its index in its May 2008 semi-annual report. *Id.* at 936; SAC ¶¶ 96–97. The district judge then dismissed the contract claims, with prejudice, for failure to state a claim on the ground that they were barred by SLUSA, and that they failed to allege a contract between the shareholders and the Fund. *Northstar*, 781 F. Supp. at 933–40. The district judge also rejected Northstar's breach of fiduciary duty causes of action under SLUSA, but gave Northstar leave to replead them under Massachusetts law. *Id.*

Northstar repled the fiduciary duty causes of action in its Third Amended Complaint and also amended its allegations in an effort to remove their supposed focus on misrepresentations. Indeed, the Schwab defendants conceded in their motion to dismiss the Third Amended Complaint that "Northstar avoided SLUSA preemption for its fiduciary breach claims by asserting them under Massachusetts law and coming within the 'Delaware carve-out'"—a term used to describe an exception to SLUSA preemption if such a cause of action is available under the law of the state that had chartered or organized the entity issuing the securities. Def. Mot. to Dismiss Third Am. Compl. 13 n.5; *see* 15 U.S.C. § 77p(d)(1); *Madden v. Cowen & Co.*, 576 F.3d 957, 971 (9th Cir. 2009). Nevertheless, the district judge held that the fiduciary duty claims had to be brought derivatively, and dismissed them. *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 807 F. Supp. 2d 871, 876–81 (N.D. Cal. 2011). The district judge also held that Northstar could not assert a claim as a third-party beneficiary of the Investment Advisory Agreement. *Id.* at 881–84. Presumably because she had dismissed the breach of contract cause of action in the Second Amended Complaint with prejudice, she did not address Northstar's arguments as to these claims in the Third Amended Complaint. Nor did the district judge decide whether the allegations in the Third Amended Complaint survived under SLUSA.

As we discuss in detail below, we reverse the district court's dismissal of the breach of contract claims for failure to allege a contract between the shareholders and the Fund. We also reverse the district court's dismissal of the fiduciary duty and third-party beneficiary claims. We do not, however, reach the question of whether any of

Northstar's claims are barred by SLUSA. The district court has not yet had the need to determine whether the allegations in the Third Amended Complaint can survive under SLUSA, and should do so in the first instance. *See, e.g., Haskell v. Harris*, 745 F.3d 1269, 1271 (9th Cir. 2014) ("[W]e are a court of review, not first view.").

With this as a backdrop, we proceed to discuss the merits of Northstar's complaint.

### *A. Breach of Contract Claim*

Northstar argues that, once the shareholders approved the proposals regarding the fundamental investment objectives of the Schwab Trust, which were described in the proxy statement, the Schwab Trust was contractually obligated to comply with them in managing the Fund. Moreover, Northstar argues that the subsequent dissemination of the fundamental investment objectives in the registration statement and prospectuses formed a contract between the Schwab Trust and the "existing investors [who] retained shares and new investors [who] purchased shares in consideration for Schwab's contractual obligations." Appellant's Br. at 21; *see also* Appellant's Reply Br. at 7 n.8.

The Restatement (Second) of Contracts provides that "[a] promise may be stated in words either oral or written, or may be inferred wholly or partly from conduct." Restatement (Second) of Contracts § 4 (1981). While contracts are often spoken of as express or implied, "[t]he distinction involves . . . no difference in legal effect, but lies merely in the mode of manifesting assent." *Id.* cmt. *a.* "Just as assent may be manifested by words or other conduct, sometimes including silence, so intention to make a promise may be manifested in language or by implication from other circumstances, including course of dealing or usage of trade or course of performance." *Id.* "The distinction between an express and an implied contract, therefore, is of little importance, if it can be said to exist at all." 1 Joseph M. Perillo, *Corbin on Contracts* § 1.19 at 57 (rev. ed. 1993); see also 1 Richard A. Lord, *Williston on Contracts* § 1:5 at 37–38 (4th ed. 2007) ("An implied-in-fact contract requires proof of the same elements necessary to evidence an express contract: mutual assent or offer and acceptance, consideration, legal capacity and a lawful subject matter.").

While it is not necessary to characterize the contract here as either express or implied, a particularly instructive discussion of the concept of implied contracts, in circumstances analogous to those present here, appears in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819), one of the earliest cases applying Article I, Section 10 of the Constitution, which provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of

Contracts." The case arose out of an effort by the State of New Hampshire to alter the terms of a corporate charter that had provided certain guarantees as to the structure and governance of Dartmouth College. As Professor Tribe succinctly describes it, the Supreme Court "held that New Hampshire could not pack the Dartmouth College board of trustees and alter its faculty so as to change the college into a public institution in violation of its 1769 charter from George III." Laurence H. Tribe, *American Constitutional Law* 614 (2d ed. 1988). Of particular relevance here is the concurring opinion of Justice Story, who began his discussion of this issue by describing the creation of the corporation and the terms of its charter. Specifically, he observed:

> The corporation was expressly created for the purpose of distributing in perpetuity the charitable donations of private benefactors. By the terms of the charter, the trustees, and their successors, in their corporate capacity, were to receive, hold and exclusively manage all the funds so contributed. The crown, then, upon the face of the charter, pledged its faith that the donations of private benefactors should be perpetually devoted to their original purposes, without any interference on its own part, and should be for ever

> administered by the trustees of the corporation, unless its corporate franchises should be taken away by due process of law.

*Dartmouth College*, 17 U.S. (4 Wheat.) at 689.

Justice Story then identified two implied contracts in this circumstance. First, "there was an implied contract on the part of the crown, with every benefactor, that if he would give his money, it should be deemed a charity protected by the charter, and be administered by the corporation, according to the general law of the land. As, soon, then, as a donation was made to the corporation, there was an implied contract . . . that the crown would not revoke or alter the charter, or change its administration, without the consent of the corporation." *Id.* Second, "[t]here was also an implied contract between the corporation itself, and every benefactor, upon a like consideration, that it would administer his bounty according to the terms, and for the objects stipulated in the charter." *Id.* at 689–90.[6]

The fundamental investment objectives of the Schwab Total Bond Market Fund can be analyzed in the same manner. Indeed, when they were adopted by the shareholders, they added a

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[6] Justice Story's opinion was a concurrence and was joined by Justice Livingston. The opinion of the Court was written by Chief Justice Marshall, who agreed that the charter constituted a contract. *Id.* at 643–44, 651.

structural restriction on the power conferred on the Trustees in the Agreement and Declaration of Trust that can only be changed by a vote of the shareholders. This created a "contract between the [Trustees themselves], and every [investor]"—that the Schwab Trust "would administer his [investment] according to the terms, and for the objects stipulated in the" two restrictions adopted by the shareholders of the Fund. *Id.* at 690–91. Significantly, after the shareholders voted in favor of the proxy statement that included these restrictions, they were subsequently reflected in the Fund's registration statements and prospectuses. Thus, anyone who purchased shares in the Fund after 1997, or held shares that he then owned, was legally and contractually entitled to have his investment managed in accordance with the proposals in the proxy statement, unless the shareholders voted to permit otherwise.

The defendants argue that undertakings in SEC filings themselves cannot reflect contractual obligations that can be enforced in a suit for breach of contract. This argument cannot be reconciled with *Lapidus v. Hecht*, 232 F.3d 679 (9th Cir. 2000), where the plaintiffs sought "to recover losses sustained by the mutual funds as a result of short sales made without shareholder approval, allegedly in violation of the registration statement filed with the Securities and Exchange Commission." *Id.* at 680. Specifically, the defendant, a Massachusetts business trust, had filed a "prospectus . . . with the SEC [that] provided that the trust could engage in short sales of securities with a value of up to 25% of the value of the mutual fund's total assets."[7] *Id.* at 681. The trust later issued an amended prospectus which "authorized the trust to enter into short sales of securities with a value of up to 40% of the mutual fund's total assets." *Id.* Nevertheless, "[t]his amendment to the short sales restriction was made without shareholder approval" and, subsequently, "the mutual fund's short sale position had increased to 25–35% of the mutual fund's assets and the mutual fund suffered substantial losses." *Id.*

On appeal, we addressed whether the plaintiffs could bring their action for violations of the ICA directly against the defendant or whether the action had to be brought derivatively. We held that the *Lapidus* plaintiffs had adequately alleged an injury "predicated upon a violation of [the] shareholder's voting rights," *id.* at 683 (citing cases), and that those "allegations are sufficient to satisfy the injury requirement for a direct action under

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[7] A registration statement must "include[] the information required in a Fund's prospectus[.]" Sec. & Exch. Comm'n, Form N-1A at 7, *available at* http://www.sec.gov/about/forms/formn-1a.pdf (last visited Aug. 29, 2013). *Lapidus* appears to use the terms "registration statement" and "prospectus" interchangeably.

Massachusetts law," *id.* Significantly, the violation held to be adequately alleged was of the plaintiffs' "*contractual rights as shareholders* to vote on proposed changes to the short sale and senior security restrictions." *Id.* (emphasis added). These restrictions were spelled out in the registration statement, *id.*, and in the "prospectus filed with the SEC," *id.* at 681. *Lapidus's* holding is directly applicable here because Northstar's breach of contract cause of action rests on the deviation by defendants from two fundamental investment objectives, which required a shareholder vote to be changed, without first obtaining shareholder approval. Until the fundamental investment objectives were amended by shareholder vote, the investors had a contractual right to have the Fund managed in accordance with those objectives.[8]

*McKesson HBOC, Inc. v. New York State Common Retirement Fund, Inc.*, 339 F.3d 1087 (9th Cir. 2003), upon which the district judge relied, does not support the defendants' argument. In that case:

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[8] We rely on *Lapidus* at this juncture solely for its holding that undertakings in SEC filings may give rise to an implied contractual obligation. We discuss at pages 45 to 47 below, the effect of the holding of *Lapidus* on whether an action for breach of contract and breach of fiduciary duty may be brought directly.

> McKesson HBOC [sued] its own shareholders for unjust enrichment arising from a merger between McKesson and HBO & Company ("HBOC"). McKesson claim[ed] that the former HBOC shareholders [we]re the beneficiaries of a windfall triggered by alleged accounting improprieties by HBOC. The shareholders, according to McKesson, exchanged artificially inflated shares of HBOC for fully-valued McKesson shares in the merger transaction. McKesson [wanted] to recover the excess value from the shareholders.

*Id*. at 1089. McKesson sought recovery for unjust enrichment, which was potentially available only if there was no governing contract between the parties. *Id*. at 1089, 1091. While *McKesson HBOC* ultimately held that there was no recovery for unjust enrichment, even if there were no governing contract, it first addressed whether the Merger Agreement or the relevant Proxy Statement/Prospectus ("Prospectus") was a contract that governed McKesson's claims against the shareholders.

First, *McKesson HBOC* held that "it is clear from the text and the signatories to the agreement that the only parties to the Merger Agreement were the corporations themselves." *Id*. at 1091. Second, it held that "the Prospectus was not an offer by McKesson to the HBOC shareholders to enter into a bilateral contract separate and apart from the Merger Agreement." *Id*. at 1092. Specifically, *McKesson HBOC* explained that, although the "Prospectus references the Merger Agreement, advising shareholders that '[t]he merger cannot be completed unless the stockholders of both companies approve the merger agreement and the transactions associated with it,'" such "references do not . . . convert McKesson's solicitation of the shareholders' vote into a contractual offer." *Id*. Thus, *McKesson HBOC* concluded that "the Prospectus did not serve as the basis for a contract between McKesson and the shareholders." *Id*. at 1093.

Significantly, *McKesson HBOC* distinguished the scenario it addressed from a "tender offer situation, where the courts have found a contract between the corporation and an individual shareholder who tenders shares[.]" *Id*. at 1092; *see also* 6A Fletcher Cyc. Corp. § 2841.10 at 358 (rev. ed. 2013) ("A binding contract is created when the shareholder tenders his or her securities in accordance with the terms of the offer."). Unlike a tender offer, "the shareholders [in McKesson] did not tender their shares." *McKesson HBOC*, 339 F.3d at 1092–93. Moreover, "shareholders who objected to the merger could not separately opt out or contract out of the merger. Individual shareholders were not in a position of contracting with McKesson, and shareholder ratification did not convert the Prospectus into a contract." *Id* at 1093.

This case is clearly distinguishable from *McKesson HBOC*. First, the parties to the contract at issue in this case are the Trustees and the shareholders of the Fund. Second, the breach of contract cause of action is predicated, in part, on the approval of the fundamental investment objectives by the shareholders. Once those objectives were adopted, they significantly restricted the discretion which the Agreement and Declaration of Trust conferred on the Schwab Trust to manage the Fund. Moreover, the Fund's registration statement and prospectuses reflected the adoption of those restrictions. The acquisition of the securities constituted an acceptance of the offer.

Nor does *In re Charles Schwab Corp. Securities Litigatio*n, No. C 08-01510 WHA, 2009 WL 1371409 (N.D. Cal. May 15, 2009) [hereinafter "*Charles Schwab*"], on which defendants rely, and which involved legal issues comparable to this case, constitute persuasive authority to the contrary. The district judge there first stated that "[t]he Ninth Circuit has never addressed whether mutual fund disclosure documents constitute a contract under these precise circumstances." *Id.* at *3. Nevertheless, as *Lapidus* makes clear, this is not an accurate statement of Ninth Circuit law. *See* 232 F.3d at 683. Moreover, we do not find persuasive the argument that *Lapidus* is distinguishable because it "did not involve contract claims but rather statutory claims under the [ICA.]" *Charles Schwab*, 2009 WL 1371409, at *5. The plaintiffs' ability in *Lapidus* to bring a direct action under the ICA was based upon a breach of their "contractual rights as shareholders to vote on proposed changes to the short sale and senior security restrictions[.]" *Lapidus*, 232 F.3d at 683. These contractual rights were derived from the registration statement and the prospectus. *Id*. at 681, 683.

We find equally unpersuasive the argument that "the prospectuses . . . here at issue are not contracts but rather are *mandatory* regulatory disclosure documents." *Charles Schwab*, 2009 WL 1371409, at *3. The prospectus, which is the primary selling document, offers to sell shares to investors in a mutual fund which will invest the proceeds in the manner described in the prospectus, unless shareholders approve a proposal to do otherwise. Indeed, the Securities and Exchange Commission urges investors to "request and read the fund's prospectus before making an investment decision." *Mutual Fund Prospectus*, Sec. & Exch. Comm'n, http://www.sec.gov/answers/mfprospectustips.htm (last visited Sept. 5, 2014). The mere fact that Congress has chosen to ensure that investors are fully informed of the fundamental investment objectives of mutual funds hardly provides a license to ignore the objectives, enshrined by shareholder approval, which a mutual fund has obligated itself to pursue. Nor does it alter the fact that the purchase of those shares constitutes an acceptance of the offer by the investor. Indeed, as previously observed, this is precisely how the shareholders became parties to the Agreement and Declaration of Trust. Agreement and Declaration of Trust 4 ("Every Shareholder by virtue of having become a Shareholder shall be held to have expressly assented and agreed to the terms hereof and to have become a party hereto.").

Moreover, the district judge in *Charles Schwab* did not cite any authority for his suggestion that a "mandatory regulatory disclosure document" cannot form the basis for an implied contract. *Lapidus* holds otherwise and the district judge in *Charles Schwab* acknowledged that, "in certain circumstances prospectuses can constitute a contract." *Charles Schwab*, 2009 WL 1371409, at *5. Indeed, even before the enactment of the Securities Act of 1933, "the term 'prospectus' was well understood to refer to a document soliciting the public to acquire securities from the issuer." *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 575 (1995) (citing *Black's Law Dictionary* 959 (2d ed. 1910)).

In sum, we conclude that the mailing of the proxy statement and the adoption of the two fundamental investment policies after the shareholders voted to approve them, and the annual representations by the Fund that it would follow these policies are sufficient to form a contract between the shareholders on the one hand and the Fund and the Trust on the other. The Fund offered the shareholders the right to invest on these terms, and the shareholders accepted by so investing. The consideration for the contract was the shareholders' investment, or continued investment, in the Fund, and the parties' object was lawful. The conduct of the parties thus fulfills all the requirements for a binding contract under traditional common law principles. *See* Lord, *Williston on Contracts* § 1:5 at 37–38 (4th ed. 2007).

We are aware that Judge Koh held that, under the particular circumstances of this case, Northstar failed to successfully allege the formation and breach of a contract. 781 F. Supp. 2d at 939. She reasoned that:

> [A] September 1, 2006 Statement of Additional Information was issued which stated that the Fund would, from then on, cease to treat "mortgage-backed securities issued by private lenders" as a separate industry and therefore could invest more than 25% of the Fund's assets in this area would seem to defeat Plaintiffs' contract claim. If this became a term of the contract between Plaintiffs and the Trust

> when investors held or subsequently purchased shares, then the Trust could not have breached this contract by over-investing in MBS, as Plaintiffs claim.

*Id.* at 940.

We are not persuaded. Northstar alleged that the SAI's statement that "the funds have determined that mortgage-backed securities issued by private lenders are not part of any industry for the purposes of the funds' concentration policies," *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, No. 5:08-cv-04119-LHK (N.D. Cal.), Statement of Additional Information (Sept. 1, 2006) at 8, Doc. No. 152-2, was an improper attempt to circumvent the Fund's concentration policy that limited investment in one industry to 25% of its assets because no vote was taken to approve it. This position was supported by a complaint filed by the Securities and Exchange Commission, which alleged "that the Schwab trust deviated from its policy on concentration for the Schwab Total Bond Market Fund . . . by deciding to not treat mortgage-backed securities as an industry without shareholder approval." Appellees' Br. 13 (citing *SEC v. Charles Schwab Inv. Mgmt. Inc.*, No. 11-cv-00136 (N.D. Cal.), Compl. ¶¶ 24–28, Doc. No. 1).

Specifically, the SEC charged that before August 2006, the 25% concentration policy stated that "[b]ased on characteristics of mortgage-backed securities, [the Total Bond Fund] has identified mortgage-backed securities issued by private lenders and not guaranteed by the U.S. government agencies or instrumentalities as a separate industry for purposes of [the] fund's concentration policy." *SEC v. Charles Schwab Inv. Mgmt. Inc.*, No. 11-cv-00136 (N.D. Cal.), Compl. ¶ 25, Doc. No. 1; *see also* Schwab Investments, Statement of Additional Information (Form N-1A, Part B) 9 (Nov. 15, 2004). The position of the SEC was that, because Schwab had identified mortgage-backed securities issued by private lenders as an industry, "the Total Bond Fund could not invest more than 25% of [its] assets in non-agency MBS without obtaining shareholder approval under Section 13(a)" of the ICA. *SEC v. Charles Schwab Schwab Inv. Mgmt. Inc.*, No. 11-cv-00136 (N.D. Cal.), Compl. ¶ 25.

Judge Koh's reliance on the September 1, 2006 SAI, even if correct, overlooks the fact that the Fund's concentration policy was only one of the two fundamental investment objectives from which the defendants could not depart without shareholder approval. The primary violation was "causing the Fund to deviate from its fundamental investment objective to 'seek to track the investment results' of the Lehman Brothers U.S. Aggregate Bond Index . . . 'through the use of an indexing strategy.'" The complaint then goes on to allege that the "Fund also deviated from its stated fundamental investment objective by investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed securities and CMOs."

The SAI did not provide any notice that the defendants intended to depart from the first of the fundamental objectives which obligated the Fund to "seek to track the investment results" of the Lehman Index. Thus, even if Judge Koh was correct in her analysis with respect to the breach of the second investment objective, as to which notice was provided in the SAI, the complaint still sufficiently states a claim for breach of contract. This is true with respect to those who purchased before September 1, 2006 and held on to their shares afterward, and those who purchased after that date.

Particularly as to those who purchased before September 1, 2006 and held onto their shares, we are not prepared to assume that the SAI itself was sufficient to provide adequate notice. An SAI, "affords the Fund an opportunity to expand discussions of the matters described in the prospectus by including additional information that the Fund believes may be of interest to some investors." Glazer, *Prospectus Disclosure and Delivery Requirements, in Mutual Fund Regulation* § 4:3.2 (quoting Sec. & Exch. Comm'n, Form N-1A at 7, *available at* http://www.sec.gov/about/forms/formn-1a.pdf (last visited Sept. 5, 2014)). "The SAI is not automatically provided investors but must be available free of charge upon request.” *Id.* Moreover, the SAI may be specifically incorporated “by reference into the prospectus without delivering the SAI with the prospectus.” *Id.* § 4:3.1[D]. While there may be sophisticated shareholders who make the effort to ask for an SAI or read it with the care necessary to digest the relevant parts of a long and multifaceted document, we think it is reasonable to assume that there are many ordinary shareholders who do not do so. Indeed, even if a mutual fund could alter a fundamental investment objective by the vehicle of an SAI, it should provide current shareholders with clear and unambiguous notice of the alteration that it wishes to make.

### *B. Breach of Fiduciary Duty Claim*

Northstar alleged that the Schwab defendants breached their fiduciary duties by failing to ensure that the Fund was managed in accordance with the fundamental investment objectives and by changing the Fund’s fundamental investment objectives without obtaining required shareholder authorization. The district judge held that Northstar “failed to successfully allege a breach of any duty owed directly to Fund investors, and that these claims would have to be asserted derivatively.” *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 807 F. Supp. 2d 871, 876 (N.D. Cal. 2011).

Defendants conceded at oral argument that the allegations in the operative complaint are sufficient to state a cause of action for breach of fiduciary duty. They argue, however, that the Trustees did not owe a fiduciary duty to the beneficiaries of the Schwab Trust—namely, the shareholders. Instead, they argue that because of the "close resemblance of a mutual fund operated as a Massachusetts Business Trust to a corporation," the Trustees should be treated in the same way as corporate directors, who "owe fiduciary duties to the corporation rather than to its shareholders." Appellees' Br. at 48. This argument provides the predicate for the claim that Northstar was required to proceed by way of a derivative action.

There are several deficiencies in this argument. First, it simply ignores the plain terms of the Agreement and Declaration of Trust.

The document states expressly that:

> the Trustees hereby declare that they will hold all cash, securities and other assets, which they may from time to time acquire in any manner as Trustees hereunder IN TRUST to manage and dispose of the same . . . for the pro rata benefit of the holders from time to time of Shares in this Trust.

Agreement and Declaration of Trust 1. We are not aware of any Massachusetts case that holds that agreements of this kind cannot be enforced directly by the beneficiaries of a trust.

Second, the Supreme Judicial Court of Massachusetts has held that "[i]t is axiomatic that the . . . trustees [stand] in a fiduciary relationship to all the beneficiaries of the trust." *Fogelin v. Nordblom*, 521 N.E.2d 1007, 1011 (Mass. 1988); *see also* Dukeminier, Sitkoff & Lindgren, *Wills, Trusts, and Estates* 556 ("In managing the portfolio, [the trustee] is subject to a fiduciary obligation to" the investors in the mutual fund); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165, 166 (1997) ("The familiar standards of trust fiduciary law protect trust beneficiaries of all sorts, regardless of whether the trust implements a gift or a business deal (unless, of course, the terms of the transaction expressly contraindicate)."). While the Supreme Judicial Court of Massachusetts has acknowledged similarities between corporations and business trusts, it has held that business trusts "are not corporations, nor are they entities apart from the trustees." *Swartz v. Sher*, 184 N.E.2d 51, 53 (1962). Under these circumstances, there is no logical basis for the argument that the trustees of a mutual fund organized as a Massachusetts business trust owe a fiduciary duty to the trust, rather than the shareholders, and that for this reason they are limited to a derivative action on behalf of the trust.

*Lapidus v. Hecht*, 232 F.3d 679 (9th Cir. 2000), upon which defendants rely, does not support their position. *Lapidus* involved two discrete claims of wrongdoing. The first, which is comparable to the cause of action here, was based on deviations from the investment objectives of the mutual fund and the issuance of senior securities without shareholder approval. *Id.* at 681 (citing 15 U.S.C. § 80a-13(a)(2)–(3)). The second cause of action involved the issuance of senior securities in violation of section 15 U.S.C. § 80a-18(f).

*Lapidus* first addressed the issue of whether a direct action could be brought for the departure from the mutual fund's investment objectives and the issuance of senior securities without shareholder approval. *Lapidus*, 232 F.3d at 683. We held that, "[t]o bring a direct action under Massachusetts law, a plaintiff must allege an injury distinct from that suffered by shareholders generally *or* a wrong involving one of his or her contractual rights, *such as* the right to vote. *Lapidus*, 232 F.3d at 683 (emphasis added). We then went on to observe that the plaintiffs alleged "violations of their contractual rights as shareholders to vote on proposed changes to the short sale and senior security restrictions." *Id.* Such claims could be brought directly. *Id.*

*Lapidus* then addressed the second cause of action based on "the allegedly improper issuance of senior securities," *id.* at 683, in violation of federal law, *id.* at 681 n.3. This action could not be brought directly because it failed both parts of the disjunctive test. First, the injury was not distinct from the injury to all shareholders holding the same series of stock because the alleged improper "issuance of senior securities . . . would be an injury to the trust generally." *Id.* at 683. Second, the alleged improper issuance was "unconnected to any violation of voting rights" or any other contractual right. *Id.*

The first prong of the test was applied with respect to both causes of action in *Lapidus*, namely, that to bring a direct action under Massachusetts/Delaware law, "a plaintiff must allege an injury distinct from that suffered by shareholders generally." *Id.* We refer to "Massachusetts/Delaware" law because *Lapidus* relied on two Delaware cases and one Massachusetts case applying Delaware law for the circumstances under which a direct action may be brought "under Massachusetts law[.]" 232 F.3d at 683. The Delaware law has since changed. Thus, in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1036–39 (Del. 2004), the Supreme Court of Delaware rejected, as "confusing," the concept "that an action cannot be direct if all stockholders are equally affected or unless the stockholder's injury is separate and distinct from that suffered by other stockholders." *Id.* at 1038–39.

Moreover, even if that prong survived the holding in *Tooley*, a direct action in this case would be appropriate under the second prong of the disjunctive test applied in *Lapidus* because the plaintiffs allege "a wrong involving one of [their] contractual rights as . . . shareholder[s]." 232 F.3d at 683. Northstar's breach of contract cause of action rests on the deviation by defendants from two fundamental investment objectives, which required a shareholder vote change, without first obtaining shareholder approval. The right to vote, however, is not the only contractual right at issue. Instead, it is inextricably intertwined with the restrictions placed on the power of the Trustees to invest the assets of the Fund. Until the fundamental investment objectives were amended by shareholder vote, the investors had a contractual right to have the Fund managed in accordance with those objectives.

The third deficiency in defendants' argument that this action must be brought derivatively is that the distinction between direct and derivative actions has little meaning in the context of mutual funds, at least on the facts present here. A publicly held corporation, in contrast to a mutual fund, engages in a business, *e.g.*, the buying and selling of widgets, in which the accretion of share price is generally the by-product of business success, and the depletion of share price can be the by-product of either unsuccessful business decisions or misconduct by fiduciaries. The particular facts in the latter scenario will determine whether claims against corporate officers are derivative or direct in nature (or both). *See Tooley*, 845 A.2d 1031. In a mutual fund, however, there is no business other than acquiring investment instruments for the purpose of increasing the net asset value "for the pro rata benefit of the holders . . . of Shares in this Trust." Agreement and Declaration of Trust 1. Any decrease in a mutual fund's share price flows directly and immediately to the shareholders. This is particularly true when such an injury results from the failure to comply with a fund's fundamental investment objectives. Thus, such misconduct supports a direct action.

There may be scenarios where a mutual fund trustee can be sued only derivatively—for example, if he embezzles assets held by the fund, the injury may be first to the mutual fund and only secondarily to the investors in the fund. But that is not this case. Rather, this case alleges a failure to follow trading restrictions, the very essence of the Fund's business, which, accepting the allegations as true, caused a diminution in shareholder value. The claim supports a direct action because the impact is directly on the investors in the Fund and a recovery would not be dependent on demonstrating an injury to the Schwab Trust. *Cf. Tooley*, 845 A.2d at 1039 (holding that a corporate stockholder who brings a direct action "must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation").

Even if we were to accept defendants' attempt to analogize the Fund to a publicly held corporation, their argument that Northstar may only sue derivatively would fail. Significantly, the Principles of Corporate Governance promulgated by the American Law Institute ("ALI") recognize that in circumstances comparable to this case, a direct action may be appropriate. Thus, in a comment to § 7.01, the section that is captioned "Direct and Derivative Actions Distinguished," the ALI observes:

> In some instances, actions that essentially involve the structural relationship of the shareholder to the corporation (which thus should be seen as direct actions) may also give rise to a derivative action when the corporation suffers or is threatened with a loss. One example would be a case in which a corporate official knowingly acts in a manner that the certificate of incorporation denied the official authority to do, thereby violating both specific restraints imposed by the shareholders and the official's duty of care. In such cases,

> the plaintiff may opt to plead either a direct or a derivative action, or to bring both actions simultaneously, unless the court finds that the plaintiff is unable to provide fair and adequate representation pursuant to § 7.02(a)(4) (Standing to Commence and Maintain a Derivative Action).

American Law Institute, *Principles of Corporate Governance* § 7.01, cmt. c (1994).[9]

The present case involves the same kind of structural relationship of shareholders to the Schwab Trust that the foregoing comment

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[9] The Chief Reporter's foreword states that "Comments express the views of the [American Law] Institute." ALI, *Principles of Corporate Governance XXV*. Section 7.01, to which this comment applies, has been repeatedly cited with favor by the Supreme Court of Delaware. See Tooley, 845 A.2d at 1036; *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). Indeed, in *Grimes*, the Supreme Court of Delaware expressly cited and applied the comment quoted above. *Id*. at 1213. While the present case does not directly involve the application of Delaware law, Delaware has been described aptly as "by far the most important corporate jurisdiction[.]" Melvin Aron Eisenberg & James D. Cox, *Corporations and Other Business Organizations* 1031 (10th ed. 2011). Indeed, as we previously observed, in *Lapidus* we relied on two Delaware cases and one Massachusetts case applying Delaware law for the circumstances under which a direct action may be brought "under Massachusetts law[.]" 232 F.3d at 683.

addresses. Of course, we deal here with an agreement and declaration of trust rather than a certificate of incorporation. The adoption by the shareholders of the fundamental investment objectives of the Fund effectively imposed a restraint on the structural relationship in the Agreement and Declaration of Trust comparable to an amendment of a certificate of incorporation. The allegations in the complaint, although not *in haec verba*, are sufficient to support an argument that the Trustees "violat[ed] both specific restraints imposed by the shareholders and the official[s'] duty of care." ALI, *Principles of Corporate Governance* § 7.01, cmt. *c*. Thus, even if the same rules that apply to corporations are applied to the Schwab Trust, this is the kind of case in which "the plaintiff may opt to plead either a direct or a derivative action[.]" *Id.*

Moreover, there is another reason, directly rooted in Massachusetts case law, which provides a basis for permitting a direct action even against a corporation. While Massachusetts cases generally preclude direct actions "where corporate recovery for misdeeds by a corporate fiduciary is available under traditional corporate law," they contain the significant caveat that "such recovery [must] provide[] a just measure of relief to the complaining stockholder[.]" *Crowley v. Commc'ns for Hosps., Inc.*, 573 N.E.2d 996, 1004 (Mass. App. Ct. 1991); *see also Diamond v. Pappathanasi*, 25 Mass. L. Rptr. 500, 2009 WL

1539792, at *7 (Mass. Super. Ct. 2009) ("[S]hareholders may resort to a direct, personal action against a miscreant fiduciary where . . . a corporate recovery would not provide a just measure of relief to the complaining shareholder."). We have likewise acknowledged that, even where corporate shareholders have been relegated to pursue their claims in a derivative action, a direct action may be appropriate to provide a remedy to shareholders who have been injured and who would not recover under the traditional rules governing derivative actions. *See, e.g.*, *Eagle v. Am. Tel. & Tel. Co.*, 769 F.2d 541, 546 (9th Cir. 1985).

This case is one in which a recovery by the Schwab Trust "would not provide a just measure of relief to the complaining shareholder." *Diamond*, 2009 WL 1539792, at *7. Any recovery in a derivative action would simply increase the net asset value of the Fund at the time any damages were recovered. Consequently, as defendants conceded at oral argument, if a derivative suit is successfully prosecuted, all current shareholders would participate in the recovery by the Schwab Trust even if they were not shareholders during the relevant time period, and injured former shareholders would not necessarily participate in the recovery at all.

Significantly, the remedy agreed to in an enforcement action by the SEC avoids such "a[n] [un]just measure of relief to the complaining [shareholders].” *Crowley*, 573 N.E.2d at 1004. The action, as we have previously observed, was based on the allegation “that the Schwab Trust improperly deviated from its policy on concentration for the [Fund] . . . by deciding to not treat mortgage-backed securities as an industry without shareholder approval.” Appellees’ Br. at 13 (citing *SEC v. Charles Schwab Inv. Mgmt. Inc.*, No. 11-cv-00136 (N.D. Cal.), Compl. ¶¶ 24–28, Doc. No. 1). A consent judgment was entered requiring the Schwab Trust to disgorge profits and prejudgment interest. Appellees’ Br. at 13–14 (citing *SEC v. Charles Schwab Inv. Mgmt. Inc.*, No. 11-cv-00136 (N.D. Cal.), Consent to Enter J. ¶ 2, Doc. No. 2). The Schwab Trust, however, did not share in the recovery. Instead, the settlement proceeds were deposited by the defendants into “a fund for distribution to adversely affected investors, including investors in the [Fund.]” Appellees’ Br. at 14 (citing *SEC v. Charles Schwab Inv. Mgmt. Inc.*, No. 11-cv-00136 (N.D. Cal.), Order Approving Distribution Plan with Modification, Doc. No. 37). This kind of remedy could be obtained if this direct class action is successful.

*Halebian v. Berv*, 931 N.E.2d 986 (Mass. 2010), upon which defendants rely, does not compel a contrary result. The defendants correctly argue that *Halebian* held, in an appropriate case, a shareholder of a mutual fund may be forced to resort to making a demand on the Trustees to file a derivative action. Nevertheless, *Halebian* did not address the circumstances under which such a course of action would be required. Instead, it held that "the statute regulating derivative actions [Mass. Gen. Laws ch. 156D, §§ 7.40–7.47] applies to a shareholder bringing such a claim against a corporation or a business trust." *Id.* at 988 n.4. Because the plaintiff had filed a derivative action, *Halebian* went on to address the narrow issue of "whether the Legislature intended that the provisions for dismissal under § 7.44 apply *only* to derivative proceedings that are 'commenced after rejection of a demand,' or to any derivative proceeding where a plaintiff shareholder's demand has been rejected by the corporation." *Id.* at 989.

Moreover, the allegations in that case were quite unlike the misconduct alleged here. In *Halebian*, the plaintiff claimed that the trustees failed to engage in competitive bidding in their selection of an investment adviser. *Id.* at 988. A derivative suit was arguably appropriate in the case because the injury to the shareholders was the attenuated result of an improper trust expenditure (the investment adviser's fee).

Nor are we persuaded by the policy arguments defendants rely on to support treating this case as a derivative action. Defendants argue that "[b]y requiring shareholders to demand that a corporation bring a claim before filing a derivative action, derivative action rules allow disinterested directors to halt suits that are meritless or contrary to the corporation's interest and allow them to exercise their judgment and oversee litigation in the best interest of the company." Appellees' Br. at 46–47 (citing Mass. Gen. Laws ch 156D, § 7.42; *Daily Income Fund*, 464 U.S. at 533; *Halebian*, 457 Mass. at 626). Moreover, they go on to argue that, "applying derivative action rules in this context . . . ensures that disinterested trustees remain primarily responsible for management of a trust's litigation." Appellees' Br. at 47. This argument is particularly unpersuasive in light of the manner in which Massachusetts business trusts that operate mutual funds conduct business. The Supreme Court has recognized that mutual funds are "typically organized and underwritten by the same firm that serves as the company's 'investment advisor.'" *Kamen*, 500 U.S. at 93. They are essentially puppets of the investment adviser.

Moreover, although fund boards have been required to include a percentage of independent directors, "the definition of 'independent' is fairly loose when it comes to fund board members[.]" Shipman, *So Who Owns Your Mutual Fund?*, Wall St. J., May 5, 2003, at R1. As one commentator has observed:

> An independent director can't be an employee of the fund investment adviser or a member of the immediate family of an employee. Other restrictions also apply. But former employees of the fund's investment adviser or the adviser's affiliates are considered to be independent when it comes to serving on a fund board. So, for example, Joseph S. DiMartino, who was president of Dreyfus Corp. for a dozen years before becoming chairman of the fund boards for the Dreyfus fund group, is considered an independent director.

*Id*. Indeed, notwithstanding the requirement that 40 percent of the members of the mutual fund board be "independent" from the adviser, 15 U.S.C. § 80a-10(a), Congress required that the shareholders of the Fund approve the initial contract for any adviser. 15 U.S.C. § 80a-15. This requirement reflected the fact that the trustees of a mutual fund "cannot seriously be expected to induce arm's-length bargaining. As the SEC long ago recognized, any so-called independent directors would 'obviously have to be satisfactory to the dominating stockholders who are in a position to continue to elect a responsive board.'" *Fox*, 692 F.2d at 259 (quoting *In re Petroleum & Trading Corp.*, 11 S.E.C. 389, 393 (1942)). Under these circumstances, it is wrong to suggest that "applying derivative action rules in this context . . . ensures that disinterested trustees remain primarily responsible for management of a trust's litigation." Appellees' Br. at 47. This is particularly true here because one of the principal defendants, aside from the Trustees themselves, is the Schwab Advisor.

There are, of course, other "reasons . . . commonly advanced for distinguishing between a *derivative* action, which is brought on the corporation's behalf against either corporate fiduciaries or third persons, and a *direct* action, which is brought on a shareholder's own behalf against either corporate fiduciaries or the corporation itself." Eisenberg & Cox, *Corporations and Other Business Organizations* 1064. The first has been described as "theoretical: Since a corporation is a legal person separate from its shareholders, an injury to the corporation is not an injury to its shareholders. This proposition is somewhat dubious, because every injury to a corporation must also have an impact, however slight, on the shareholders as well." *Id.* The other, and more compelling, reasons of policy are summed up in *Watson v. Button* as follows: "(1) to avoid a multiplicity of suits by each injured shareholder, (2) to protect the corporate creditors, and (3) to protect all the stockholders since a corporate recovery benefits all equally." 235 F.2d 235, 237 (9th Cir. 1956); *see also* Eisenberg & Cox, *Corporations and Other Business Organizations* 1064.

Significantly, two of these three policy objectives, which defendants also put forward here, are ameliorated by the very nature of the class action, which is designed to avoid a multiplicity of suits by shareholders and which contain procedural mechanisms to ensure that all members of the class are treated equally. Moreover, to the extent that one of the reasons for favoring a derivative suit is a concern for the protection of creditors, it is enough to say here that the defendants do not argue that the concern is at issue in this case.

### *C. Third-Party Beneficiary Breach of Contract Claims*

The Schwab Trust entered into an agreement with the Schwab Advisor to serve as its investment adviser and administrator of the Fund. The Schwab Advisor expressly agreed to "use the same skill and care in providing such services as it would use in providing services to fiduciary accounts if it had investment responsibilities for such accounts." The principal duty of the Schwab Advisor, as prescribed in the IAA with the Schwab Trust, was to "determine from time to time what securities and other investments [would] be purchased, retained, or sold by the [Fund]." This agreement with the Schwab Advisor was expressly approved by the shareholders of the Fund. Northstar alleges that the Schwab Advisor breached the IAA by managing the Fund in a manner inconsistent with the Fund's fundamental investment objectives, and that the shareholders may hold the Schwab Advisor liable for such a breach as third-party beneficiaries of the IAA.

The IAA expressly states that it "shall be governed by the laws of the State of California." Under California Civil Code § 1559, a critical element of a third-party cause of action is a showing that the contract was "made expressly for the benefit of a third person." The phrase, however, has been held not to mean "exclusively," *Hartman Ranch Co. v. Associated Oil Co.*, 73 P.2d 1163, 1170 (Cal. 1937), "solely," *Le Ballister v. Redwood Theatres, Inc.*, 36 P.2d 827, 827 (Cal. Dist. Ct. App. 1934), or "primar[il]y," *Montgomery v. Dorn*, 145 P. 148, 151 (Cal. Dist. Ct. App. 1914), for the benefit of a third person. Similarly, the term has been construed not to require that performance be rendered "directly" to the beneficiary, *Lucas v. Hamm*, 364 P.2d 685, 688 (Cal. 1961), or that the beneficiary be specifically named or identified in the contract, *Garratt v. Baker*, 56 P.2d 225, 226 (Cal. 1936).

"Consequently, its connotative meaning having been destroyed by judicial interpretation, the term 'expressly' has now come to mean merely the negative of 'incidentally.'" Kay S. Bruce, Martinez v. Socoma Companies: *Problems in Determining Contract Beneficiaries' Rights*, 27 Hastings L. J. 137, 149 (1975) (footnotes omitted). Indeed, the Supreme Court of California has explicitly held that "[t]he effect of the section is to exclude enforcement by persons who are only incidentally or remotely benefited." *Lucas*, 364 P.2d at 689; *see also Spinks v. Equity Residential Briarwood Apartments*, 90 Cal. Rptr. 3d 453, 468 (Ct. App. 2009); Judith M. Kline & Brent A. Olson, *California Business Law Deskbook* § 8:28 (2012).

Under these circumstances, the critical issue is "'[w]hether the third party is an intended beneficiary.'" *Balsam v. Tucows Inc.*, 627 F.3d 1158, 1161 (9th Cir. 2010) (quoting *Prouty v. Gores Tech. Grp.*, 18 Cal. Rptr. 3d 178, 184 (Ct. App. 2004)). The resolution of this issue, in turn, "'involves construction of the intention of the parties, gathered from reading the contract as a whole in light of the circumstances under which it was entered.'" *Id.* (quoting *Prouty*, 18 Cal. Rptr. 3d at 184); Restatement (Second) of Contracts § 302, reporter's note ("A court in determining the parties' intention should consider the circumstances surrounding the transaction as well as the actual language of the contract." (citing cases)). "Insofar as intent to benefit a third person is important in determining his right to bring an action under a contract, it is sufficient that the promisor must have understood that the promisee had such intent." *Lucas*, 364 P.2d at 689.

Northstar has adequately alleged an "intent to benefit a third person." Northstar has also plausibly alleged that the Schwab Advisor understood that it was the intent of the Schwab Trust to benefit the shareholders of the Fund. Moreover, compelling evidence lending plausibility to the third-party beneficiary cause of action, based on the premise that the shareholders are intended beneficiaries of the IAA, is that Congress has required "that the contract between the adviser and the company be approved by a majority of the company's shareholders." *Kamen*, 500 U.S. at 93 (citing 15 U.S.C. § 80a-15(a)); *see also Navellier v. Sletten*, 262 F.3d 923, 944 (9th Cir. 2001); David A. Sturms & Renee M. Hardt, *Regulation of the Advisory Contract, in Mutual Fund Regulation* § 6:2.2 (Clifford E. Kirsch ed., 2d ed. 2005).

Thus, the agreement between the Schwab Trust and the Schwab Advisor explicitly provides "that it has been approved by a vote of a majority of the outstanding voting securities of such Schwab Fund, in accordance with the requirements under the [ICA]." This suffices to establish that the shareholders have more than a "remote" relationship to the contract between the Schwab Trust and the Schwab Advisor. Rather, it indicates the direct relationship that the shareholders have with the IAA and the fact that they are the actual beneficiaries of the IAA. Indeed, as we have held, the requirement for shareholder approval, which is imposed by the

ICA, "reflect[s] the judgment of Congress that stockholders of the investment company have a substantial interest in evaluating the new owners of an investment manager." *Zell v. InterCapital Income Sec., Inc.*, 675 F.2d 1041, 1047 (9th Cir. 1982) (citing 15 U.S.C. § 80a-15(a)(4)).

The sufficiency of the complaint is also supported by a number of California cases. Specifically, in *Gilbert Financial Corp. v. Steelform Contracting Co.*, 145 Cal. Rptr. 448 (Ct. App. 1978), the plaintiff, a property owner, entered into a contract with a general contractor for the construction of a building. The general contractor subcontracted work to the defendant. The California Court of Appeal held that the plaintiff was an intended beneficiary of the subcontract between the general contractor and the defendant, even though the plaintiff was not specifically named. *Id.* at 450. Indeed, the allegations in the complaint demonstrated that the subcontractor had, in effect, assumed the role of the general contractor to provide construction services for the plaintiff, such that the plaintiff was the "ultimate beneficiary" of the contract between the subcontractor and the general contractor. *Id.* at 451.

Applying the reasoning of *Gilbert*, the Fund's shareholders are comparable to the property owners, the Schwab Trust is comparable to the general contractor, and the Schwab Advisor is comparable to the subcontractor. The Schwab Trust engaged the Schwab Advisor to manage and operate the Fund in accordance with the fundamental investment objectives that the shareholders had adopted. In this situation, the Schwab Advisor's management of the Fund directly affected whether the Fund achieved its stated goal of tracking the Lehman Index. Thus, the "ultimate beneficiary" of the Schwab Advisor's contractual duties were the shareholders.

A more recent case, *Spinks v. Equity Residential Briarwood Apartments*, 90 Cal. Rptr. 3d 453 (Ct. App. 2009), is similarly analogous. In Spinks, an employer had contracted with a landlord to provide housing for an employee. Sometime thereafter, the employer terminated the employee and directed the landlord to change the locks on the employee's apartment, which the landlord did. The employee brought suit against the landlord as a third-party beneficiary of the contract between the employer and the landlord. The California Court of Appeal held that the employee had adequately alleged that she was an intended third-party beneficiary. *See id.* at 475. In so holding, the court noted that "the most basic aspect of [the landlord's] performance is its obligation to supply [the employer] with a place for its staff to live." *Id.* at 472. In the present case, "the most basic aspect" of the Schwab Advisor's performance—properly managing the Fund—is for the benefit of the shareholders.

Nor does the fact that the IAA contained an inurement clause providing that it "shall be binding upon and shall inure to the benefit of the parties hereto and their respective successors," preclude a third-party beneficiary action in the context of this case. The defendants cite cases holding that, because the parties specified one particular beneficiary in the contract, other beneficiaries are excluded. These cases are not dispositive. The cases upon which the defendants rely do not speak to this issue or are not controlling. For instance, *Klamath Water Users Protective Ass'n v. Patterson*, 204 F.3d 1206 (9th Cir. 1999), involved a governmental contract, not a private contract. "Parties that benefit from a government contract are generally assumed to be incidental beneficiaries, and may not enforce the contract absent a clear intent to the contrary." *Id.* at 1211. *Arista Films, Inc. Emp. Profit Sharing Plan v. Gilford Sec., Inc.*, 51 Cal. Rptr. 2d 35 (Ct. App. 1996), the only California case the defendants cite, concerned an arbitration contract, where the "overwhelming weight of authority" was against third-party enforcement, and which was governed by New York law, not California law. *Id.* at 38.

The other cases on which the defendants rely are all from courts outside California and this circuit. At this stage in the case—a motion to dismiss—we follow those courts that have ruled that any weight that should be given to an inurement clause is outweighed by the other evidence of the parties' intent. *E.g., Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 430 (S.D.N.Y. 2010); *see also Solid Host, NL v. Namecheap, Inc.*, 652 F. Supp. 2d 1092, 1119 (C.D. Cal 2009) ("Because they involve factual questions of intent, third party beneficiary claims are often not appropriate for resolution via motion to dismiss.").

Under California law, as the district judge recognized, a plaintiff may be a third-party beneficiary of a contract if he alleges that he is a member of a class named or referred to in the contract, or if the contract discharges a contractual duty owed to the plaintiff. *Northstar*, 781 F. Supp. 2d at 942–43. We hold, contrary to the district judge, that Northstar has adequately alleged the existence of a contract between the Trust and the investors. Northstar has also alleged that the IAA was designed to discharge the Trust's duties to the shareholders under this contract. Therefore, Northstar's allegations that the shareholders are third-party beneficiaries of the IAA survive the motion to dismiss.[10]

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[10] The district judge found that the Fund investors were "not explicitly mention[ed]" in the IAA. *Northstar*, 807 F. Supp. 2d at 884. This is incorrect: under Section 3 of the IAA, the Schwab Advisor explicitly contracted to "prepare the Trust's Annual and Semi-Annual Reports to Shareholders." We do not, however, rest our conclusion that Northstar has adequately alleged that the

Therefore, we hold that Northstar's allegations that the shareholders are third-party beneficiaries of the IAA survive the motion to dismiss.

**CONCLUSION**

To summarize:

1. We hold that by filing a supplemental pleading alleging a post-complaint assignment from a party that clearly had standing, Northstar has standing to prosecute this case.
2. We reverse the district judge's dismissal of Northstar's breach of contract claim and hold that Northstar adequately alleged the formation of a contract between the investors and the Schwab Trust.
3. We vacate the district judge's dismissal of the fiduciary duty claims and remand for the district judge to "address the other arguments raised by the parties regarding [Northstar's] claims for breach of fiduciary duty[.]" Northstar, 807 F. Supp. 2d at 881.
4. We reverse the district judge's dismissal of Northstar's third-party beneficiary breach of contract claim and hold that Northstar

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shareholders are third-party beneficiaries of the IAA on this one reference.

adequately alleged that the investors are third-party beneficiaries of the IAA.

5. We decline to address the effect of SLUSA on the various common law causes of action. We leave that to the district court in the first instance.

**REVERSED in part, VACATED in part, and REMANDED**.

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BEA, Circuit Judge, dissenting:

When Northstar Financial Advisors, Inc. (“Northstar”) commenced this action by filing its complaint, it did not own, nor had it ever owned any Schwab Total Bond Market fund (“Fund”) shares. Likewise, at the commencement of this action, Northstar did not own any claims of anyone who had owned any of such shares during the period when the defendants are alleged improperly to have lowered the share value of the Fund.

Hence, when Northstar sued for damages on its own behalf and for those of the class of share owners Northstar sought to represent in this class action, Northstar itself had not suffered any losses, nor did Northstar own any claims of others who had suffered losses the defendants had allegedly caused. Last, no other person who claimed to have been injured by defendants joined Northstar as plaintiff.

Defendants moved to dismiss Northstar's complaint for lack of standing, because Northstar failed to allege it had suffered an injury in fact.[1] Northstar had no "case or controversy" within the meaning of Article III of the Constitution.[2]

The district court quite properly granted defendants' motion and dismissed the complaint without prejudice,[3] but then quite misguidedly

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[1] A party seeking to invoke a federal court's jurisdiction must demonstrate three things: (1) an "injury in fact," which is an invasion of a legally protected interest that is "(a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical"; (2) a causal relationship between the injury and the challenged conduct, such that the injury can be fairly traced to the challenged action of the defendant and not from the independent action of some third party not before the court; and (3) a likelihood that the injury will be redressed by a favorable decision. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560–61 (1992) (internal quotations and citations omitted).

[2] *Cetacean Cmty. v. Bush*, 386 F.3d 1169, 1174 (9th Cir. 2004) ("A suit brought by a plaintiff without Article III standing is not a 'case or controversy,' and an Article III federal court therefore lacks subject matter jurisdiction over the suit.").

[3] An argument can be made that leave to amend was permissibly granted because it was possible that the lack of allegations constituting standing had been an

suggested that through an amended complaint, Northstar could remedy its lack of standing by an assignment of rights from a person who had been a Fund shareholder during the period when defendants allegedly injured the Fund's shareholders. More than three months later, Northstar found Henry Holz, a man who had indeed owned Fund shares during the period in question. Holz could claim injury in fact; he did have standing to sue. But for reasons best known to himself, he chose neither to sue nor to join Northstar's action. Northstar procured an assignment of Holz's claims against defendants.

Northstar then filed an amended complaint that alleged Holz's assignment of claims to Northstar. Defendants again moved to dismiss on the ground that Northstar still had not alleged facts sufficient to establish Northstar's standing to sue, only to have the district court deny the motion upon an original—but

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oversight. However, even that argument is foreclosed in this circuit. "If jurisdiction is lacking at the outset, [a] district court has no power to do anything with the case except dismiss." *Morongo Band of Mission Indians v. Cal. State Bd. of Equalization*, 858 F.2d 1376, 1380 (9th Cir. 1988) (internal quotations and citations omitted). Therefore, "[i]f jurisdiction was lacking, then [a] court's various orders, including that granting leave to amend the complaint, were nullities." *Id.* at 1381. This circuit has recognized no exceptions to *Morongo* for the retroactive cure of lack of standing through a supplemental pleading of post-complaint events.

nonetheless erroneous—theory. The district court noted that "in light of [the] previous holding that [an] assignment [of claims] would cure the [Northstar's] lack of standing, and direction to the [Northstar] to file an amended complaint based on the assignment, it would be unfair to [Northstar] to punish them for relying on the [prior district judge's] specific instructions." *Northstar*, 781 F. Supp. 2d at 932.[4] Of course, if this notion of "unfairness" were the law, parties benefitted by erroneous rulings of district courts and who took action in reliance on such erroneous rulings could not be made to give up those benefits.

Thankfully, there is no exception to the requirement of standing based on earlier district court error.[5] It is not "unfair" to lose a meritless

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4 By then the case was reassigned to another district court judge.

5 "Unfairness" based on reliance on an erroneous earlier district court ruling might be grounds for certain relief, such as tolling of a deadline. *See Smith v. Ratelle*, 323 F.3d 813, 819 (9th Cir. 2003) ("[W]e have recognized that a district court's erroneous dismissal of a mixed habeas petition is sufficiently extraordinary to justify equitable tolling."). But when a judge blows a call on *standing*, the error creates jurisdiction where the law does not, and notions of "fairness" clash with constitutional requirements. The requirement of standing ensures that courts "limit federal jurisdiction to those cases in which an adversarial setting is guaranteed by the parties' 'personal stake' in the outcome of the litigation." *LaDuke v. Nelson*, 762 F.2d 1318, 1322–23 (9th Cir. 1985)

point won earlier before an erring judge. What is "unfair" is not to apply the correct law. Here, both district court judges erred. Because Northstar failed to allege facts sufficient to constitute standing to sue in its complaint, the district court originally lacked subject matter jurisdiction. *See Cetacean Cmty. v. Bush*, 386

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(citing *Warth v. Seldin*, 422 U.S. 490, 498 (1975)). Requiring that a plaintiff have an actual injury in fact "tends to assure that the legal questions presented to the court will be resolved, not in the rarified atmosphere of a debating society, but in a concrete factual context conducive to a realistic appreciation of the consequences of judicial action." *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.*, 454 U.S. 464, 472 (1982). Of course, had Northstar accepted the dismissal without prejudice and then filed a new complaint *after* it obtained an assignment of rights, it would have had standing and a personal stake in the outcome of this litigation. The ease with which Northstar could have obtained standing makes its actions puzzling at first blush. However, had Northstar so refiled, it would also have risked its position as the first to have filed as representative of a class of plaintiffs. Any perceived impracticality of requiring Northstar to adhere to the most basic of our Constitution's standing requirements should not vitiate the need to do so. *See Sprint Commc'ns. Co. L.P, v. APCC Servs.*, 554 U.S. 269, 305 (2008) (Roberts, C.J., dissenting) ("The Court chooses to elevate expediency above the strictures imposed by the Constitution. That is a tradeoff the Constitution does not allow. . . . [T]he ease with which [plaintiff] can comply with the requirements of Article III is not a reason to abandon our precedents; it is a reason to adhere to them.").

F.3d 1169, 1174 (9th Cir. 2004). It was not even permissible to grant leave to amend to see if the standing defect could somehow be remedied. *See* Footnote 3, *supra*. But even if permissible, an amendment to allege an assignment of rights which took place over three months *after* the action was commenced was useless to allege the standing Northstar needed to commence the action in the first place. *Morongo Band of Mission Indians v. Cal. State Bd. of Equalization*, 858 F.2d 1376, 1381 (9th Cir. 1988) (citing *Mollan v. Torrance*, 22 U.S. 537, 539 (1824) (jurisdiction "depends upon the state of things at the time of the action brought"); *Nuclear Eng'g Co. v. Scott*, 660 F.2d 241, 248 (7th Cir. 1981) ("Jurisdictional questions are answered by reference to the time of the filing of an action . . . ."); *Mobil Oil Corp. v. Kelley*, 493 F.2d 784, 786 (5th Cir. 1974) (jurisdiction "is determined at the outset of the suit")). To determine federal court jurisdiction, "we look to the original, rather than to the amended[] complaint." *Id.*

The first district court judge did not have jurisdiction to grant leave to amend, and the second judge could not—out of considerations of "fairness"—allow an amendment or a supplement to an original complaint of which the district court had no subject matter jurisdiction.

The majority and the district court opinion examine the law of other circuits "because there is no published Ninth Circuit authority" as to whether "parties may cure standing deficiencies through supplemental pleadings." *Northstar*, 781 F. Supp. 2d at 933. In dicta,[6] this court reiterated the general principle that "jurisdiction is based on facts that exist at the time of filing" and noted that the "Supreme Court has enunciated few exceptions to this general principle. . . . So far, permitting standing based on a property interest acquired after filing is not one of them." *Righthaven, LLC v. Hoehn*, 716 F.3d 1166, 1171 (9th Cir. 2013).[7] In any event,

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[6] This court is bound by its own reasoned dicta. *United States v. Johnson*, 256 F.3d 895, 914 (9th Cir.2001) (en banc). *Righthaven's* dicta fits this requirement.

[7] In *Righthaven*, a media company and publisher, Stephens Media LLC, assigned its right to sue for infringement of copyright to Righthaven LLC. 716 F.3d 1166, 1168 (9th Cir. 2013). Righthaven then sued two website operators for displaying content of which Stephens Media was the original copyright owner. Id. Defendants filed motions to dismiss for lack of standing, asserting that Righthaven did not have standing to sue because Stephens Media had assigned only a bare right to sue. Under circuit law, assignment of the bare right to sue without the transfer of an associated exclusive right did not confer standing to sue on Righthaven. Id. at 1168–69. Before the district court ruled on the motions to dismiss, Righthaven and Stephens Media executed a "clarification and amendment" to the prior assignment that purported to convey all ownership rights to Righthaven. Id. at 1169. The district court granted the motions to dismiss. Id. On appeal, we affirmed because Righthaven did not have standing to sue at the time of filing, and its subsequent

even if this panel were not bound by the dicta of *Righthaven, Morongo* is dispositive: where the district court does not have subject matter jurisdiction over a matter at the time of filing, subsequent events do not confer subject matter jurisdiction on the district court. The district court has jurisdiction only to dismiss the complaint.[8]

Nevertheless, the majority cites to limited exceptions where courts have allowed the cure of jurisdictional defects other than standing through additional pleadings. In short, the district court and the majority argue that if a supplemental pleading can cure defects in the original complaint, and if that supplemental pleading can be tacked onto the original complaint, then Northstar would retroactively have standing as of its original complaint, even though "subject-matter jurisdiction depends on the state of things at the time of the action brought." *Rockwell Intern. Corp. v. U.S.*, 549 U.S. 457, 473 (2007) (internal quotations and citation omitted). This argument misses one crucial point: "[t]he state of things and the originally alleged state of things are not

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clarification and amendment did not include terms sufficient to convey an exclusive copyright. Id. at 1171.

[8] Rather than extend the length of this dissent, I recommend the reader simply read the opinions in *Morongo* and *Righthaven*, should he have any doubt as to their applicability.

synonymous." *Id.* Therefore, even if our circuit allowed supplemental pleadings to cure standing deficiencies, those supplemental pleadings must allege facts necessary to establish standing only *as those facts existed at the time of the original complaint*. This is not a novel concept in our circuit. *See Wilbur v. Locke*, 423 F.3d 1101 (9th Cir. 2005), *abrogated on other grounds by Levin v. Commerce Energy, Inc.*, 560 U.S. 413 (2010) ("[S]tanding is determined as of the date of the filing of the complaint . . . . [t]he party invoking the jurisdiction of the court cannot rely on events that unfolded after the filing of the complaint to establish its standing.") (internal quotations and citation omitted). In other words, even though "a party [may] serve a supplemental pleading setting out any transaction, occurrence, or event that happened *after* the date of the pleading to be supplemented," Fed. R. Civ. P. 15(d) (emphasis added), the facts which establish a party's standing must have existed when the original complaint was filed. Thus a Fed. R. Civ. P. 15(d) supplemental pleading cannot validly allege post-complaint transactions to cure a lack of standing.[9][10]

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[9] Of course, I do not dispute that plaintiffs may cure various jurisdictional defects—other than standing—through additional pleadings that allege relevant post-complaint events and conditions. The majority cites to several such instances (none of which are decisions from our circuit, and none of which allowed the retroactive cure of lack of allegations of injury-in-fact through a

If all an uninjured party need do to get around pesky Article III standing requirements is to file a complaint, then ask for liberal leave to supplement under Fed. R. Civ. P. 15(d) to allege after-acquired rights of those who were timely injured, the long-standing general rule which requires injury-in-fact at commencement of the action for standing to exist quickly would lose all force. Uninjured parties, particularly those in search of class action lead plaintiff status, could sue first, then trawl for those truly and timely injured. Today the majority green-lights those who would race to the courthouse and bend Federal Rules of Civil Procedure and Article III standing requirements to gain an edge over

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supplemental pleading alleging a post-complaint injury in fact). *See e.g., Newman-Green Inc. v. Alfonzo-Larrain*, 490 U.S. 826, 831–38 (1989) (the Court held that an appellate court may drop a non-diverse defendant—*under Fed. R. Civ. P. 21*—to preserve *diversity jurisdiction* over the claims of a plaintiff who suffered injury-in-fact *before* the original complaint was filed); *Prasco, LLC v. Medicis Pharm. Corp.*, 537 F.3d 1329, 1335–37 (Fed. Cir. 2008) (the Federal Circuit cited its own precedent that allows courts to look at "facts existing at the time the complaint *under consideration* was filed" (internal quotations and citation omitted) (emphasis in original)).

[10] Because I would dismiss for lack of standing, I—like the majority—express no views as to whether the Securities Litigation Uniform Standards Act would preempt Northstar's claim. I also express no views on the claims based on breach of contract, breach of fiduciary obligations, or other claimed grounds of relief. *See Righthaven*, 716 F.3d at 1773.

other claimants who are not as fleet of foot. I respectfully dissent.

**APPENDIX B – OPINION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA DECIDED MARCH 2, 2011**

**UNITED STATES DISTRICT COURT**

**NORTHERN DISTRICT OF CALIFORNIA**

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| NORTHSTAR FINANCIAL ADVISORS INC, on Behalf of Itself and All Others Similarly Situated,<br><br>Plaintiff,<br><br>v.<br><br>SCHWAB INVESTMENTS; and MARIANN BYERWALTER, DONALD F. DORWARD, WILLIAM A. HASLER, ROBERT G. HOLMES, GERALD B. SMITH, DONALD R. STEPHENS, MICHAEL W. WILSEY, CHARLES R. SCHWAB, RANDALL W. MERK, JOSEPH H. WENDER and JOHN F. COGAN, as TRUSTEES OF SCHWAB | Case No. 08-CV-04119 LHK<br><br>CORRECTED ORDER GRANTING IN PART AND DENYING IN PART DEFENDANTS' MOTION TO DISMISS |

INVESTMENTS; and CHARLES SCHWAB INVESTMENT MANAGEMENT, INC.,

Defendants.

The Court heard oral argument on defendants' Motion to Dismiss the Second Amended Complaint (Motion) in this matter on January 13, 2011. For the reasons set forth below, the Motion is GRANTED IN PART and DENIED IN PART. Plaintiffs are given leave to amend as specified in this Order.

I. Introduction and Procedural History

On August 28, 2008, Plaintiff Northstar Financial Advisors, Inc. (Northstar) filed this class action lawsuit on behalf of all persons who owned shares of the Schwab Total Bond Market Fund (the Fund) at any time from August 31, 2007 to the present. Compl. (Dkt. No. 1) ¶ 1. Northstar is a registered investment advisory and financial planning firm serving both institutional and individual clients. *Id.* ¶ 9. Northstar manages both discretionary and nondiscretionary accounts on behalf of investors in its role as an investment advisor. *Id.* Northstar traded through Charles Schwab's Institutional Advisor Platform, and purchased shares in the Fund for its clients. *Id.* ¶¶ 11-12.

Northstar alleged that defendants deviated from the Fund's investment objective to track the Lehman Brothers U.S. Aggregate Bond Index (the Index) in two ways. First, Northstar alleged that the Fund deviated from this objective by investing in high risk non-U.S. agency collateralized mortgage obligations (CMOs) that were not part of the Lehman Index and were substantially more risky than the U.S. agency securities and other instruments that comprised the Index. *Id*. ¶ 3. Second, Northstar alleged that the Fund deviated from its investment objectives which prohibited any concentration of investments greater than 25% in any industry by investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed securities and CMOs. *Id*. ¶ 4. Northstar alleged that defendants' deviation from the Fund's investment objective exposed the Fund and its shareholders to tens of millions of dollars in losses due to a sustained decline in the value of non-agency mortgage-backed securities. The Funds' deviation from its stated investment objective caused it to incur a negative total return of 1.09% for the period September 4, 2007 through August 27, 2008, compared to a positive return of 5.92% for the Index over that period. *Id*. ¶ 5.

Based on these allegations, Northstar asserted the following claims: (1) Violation of Section 13(a) of the Investment Company Act of 1940 (ICA); (2) Breach of Fiduciary Duty; (3)

Breach of Contract; and (4) Breach of Covenant of Good Faith and Fair Dealing. Defendants moved to dismiss the first complaint. See First MTD (Dkt. No. 33). Judge Illston, to whom this case was previously assigned, granted in part and denied in part defendants' motion. *See* Feb. 19, 2009 Order (Dkt. No. 74).

First, Judge Illston found that Northstar, as lead plaintiff, had no standing to sue regarding securities it had not itself invested in, but that an assignment of claim from one of its client investors "would . . . cure this deficiency." Feb. 19, 2009 Order at 4. Northstar had submitted such an assignment, dated December 8, 2008, to the Court in support of its opposition to the First MTD. *See* Finkel Decl. (Dkt. No. 39) at Ex. F. Judge Illston also granted leave to amend so that Northstar could state a claim on its own behalf. *Id*. Judge Illston also found that there was an implied private right of action under Section 13(a) of the ICA, and that Plaintiffs had stated a claim for violation of shareholders' voting rights under this section. Feb. 19, 2009 Order at 7, 9-12. Regarding the asserted state law causes of action, Judge Illston granted Plaintiffs leave to amend their breach of fiduciary duty and breach of contract claims. Regarding the breach of fiduciary duty claim, Judge Illston did not decide whether Massachusetts or California law would apply to determine whether the defendants owed investors a duty, but that the defendant's admission that "some person or entity" owed a duty to the fund's investors supported granting Plaintiffs leave to amend. Judge Illston ordered the Plaintiffs to "carefully examine whether each of the defendants named in this claim can in fact be named in such a claim, and under which state's law such a claim is properly brought." She further held that "[a]fter review of the amended complaint, defendants may renew their motion to dismiss this claim." Feb. 19, 2009 Order at 14-15. Judge Illston likewise concluded that it was unclear whether or not Plaintiffs could state a breach of contract claim based on Proxy statements and prospectuses relating to the Fund. Plaintiffs were given leave to amend to "add more specific allegations regarding the language plaintiff relies on to allege the formation of a contract, as well as each defendants' involvement." *Id.* at 15. Finally, Judge Illston found that the Plaintiffs had stated a claim for breach of the covenant of good faith and fair dealing. *Id.* at 15-16.

On March 2, 2009, Plaintiffs filed a First Amended Complaint (FAC). On March 5, 2009, defendants sought and were granted leave to appeal Judge Illston's Order finding a private right of action under the ICA § 13(a), and a stay of this action pending the appeal. See Dkt. No. 108. Thus, the case was stayed from April 27, 2009 through August 13, 2010 while the appeal was pending. In the interim, the case was reassigned, first to Judge Seeborg, and then to the undersigned. See Dkt. Nos. 115, 117. On

August 13, 2010, the Ninth Circuit reversed Judge Illston's Order, holding that there is no private right of action under Section 13(a). *Northstar Fin. Advisors, Inc. v. Schwab Invs.,* 615 F.3d 1106, 1122 (9th Cir. 2010).

In light of this, Plaintiffs filed a Second Amended Complaint (SAC) removing their Section 13(a) claim on September 28, 2010. The SAC named Schwab Investments (the Trust), its Trustees[1], and Charles Schwab Investment Management, Inc. (the Investment Advisor) as defendants. According to the SAC, the Trust is an investment trust organized under Massachusetts law, and "consists of a series of mutual funds, including the Fund." SAC ¶ 16. The Trust is managed by the Trustees. SAC ¶ 19. Pursuant to a contractual agreement between the Trust and the Investment Advisor, the Investment Advisor serves as the investment manager for the Fund. SAC ¶ 23, 154. The SAC alleges claims based on breach of fiduciary duty (against all defendants), breach of contract (against the Trust), breach of the covenant of good faith and fair dealing (against the Trust and the Investment Advisor), and a claim for third party beneficiary status to the agreement

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[1] Mariann Byerwalter, Donald F. Dorward, William A. Hasler, Robert G. Holmes, Gerald B. Smith, Donald R. Stephens, Michael W. Wilsey, Charles R. Schwab, Randall W. Merk, Joseph H. Wender and John F. Cogan

between the Trust and the Investment Advisor (against the Investment Advisor).

II. Legal Standard

Under Federal Rule of Civil Procedure 12(b)(6), a district court must dismiss a complaint if it fails to state a claim upon which relief can be granted. To survive a motion to dismiss, the plaintiff must allege "enough facts to state a claim to relief that is plausible on its face." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). This "facial plausibility" standard requires the plaintiff to allege facts that add up to "more than a sheer possibility that a defendant has acted unlawfully." *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009). In deciding whether the plaintiff has stated a claim, the Court must assume the plaintiff's allegations are true and draw all reasonable inferences in the plaintiff's favor. *Usher v. City of Los Angeles*, 828 F.2d 556, 561 (9th Cir. 1987). However, the court is not required to accept as true "allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences." *In re Gilead Scis. Sec. Litig.*, 536 F.3d 1049, 1055 (9th Cir. 2008). Leave to amend must be granted unless it is clear that the complaint's deficiencies cannot be cured by amendment. *Lucas v. Dep't. of Corr.*, 66 F.3d 245, 248 (9th Cir. 1995).

## III. Application

### a. Standing

Defendants argue that all of Plaintiffs' claims must be dismissed for lack of standing. Defendants argue that because standing must be determined at the time a complaint is filed, and because Northstar did not obtain an assignment of claims until several months after the original complaint was filed, the assignment cannot cure Northstar's original lack of standing.[2] Plaintiffs respond that Judge Illston's dismissal considered the assignment of claim that Plaintiffs now rely upon, held that this assignment would "cure this [standing] deficiency," and gave the Plaintiffs leave to file an amended complaint to cure the standing problem. Feb. 19, 2009 Order at 4.

At the hearing on this Motion, defendants focused on a Southern District of New York case finding that a lack of standing at the outset of the case was not curable via a later assignment of claim. *In re SLM Corp. Sec. Litig.*, 258 F.R.D. 112, 115 (S.D.N.Y. 2009). However, in *In re SLM*, the Southern District of New York was determining lead plaintiff status, not dismissing a claim. *Id.* In this context, the court found that

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[2] Although Judge Illston granted Plaintiffs leave to file claims directly on behalf of Northstar, Plaintiffs confirmed at the hearing on this Motion that the asserted claims are all assigned investor claims, and therefore depend on the December 8, 2008 assignment of claim.

because it had appointed a lead plaintiff who was later determined to lack standing, the better course was to appoint a new lead plaintiff who clearly possessed standing at the outset of the action rather than approving the original lead plaintiff's post-filing assignment of claim. The court noted that "[e]ven if [it] held that the assignment was sufficient to cure the lack of standing, the Court of Appeals could hold otherwise. That uncertainty requires this Court to proceed with caution. Accordingly, this Court declines to approve the assignment of claims by Westchester Capital's two client funds." Notably, in the *In re SLM* opinion, the court read Judge Illston's prior opinion in the instant case to "allow[] [Northstar] to cure its lack of standing by obtaining an assignment after the court granted the defendants' motion to dismiss." *In re SLM*, 258 F.R.D. at 115.

Many of the other cases defendants rely upon simply recite the rule that standing is considered at the outset of the litigation, but do not address how a court should treat a post-filing assignment of claim. *See, e.g., Perry v. Arlington Heights*, 186 F.3d 826, 830 (7th Cir. 1999) (dismissing claim regarding impounding of motor vehicles because plaintiff did not allege that he owned a vehicle and therefore had not been injured at the time of filing; plaintiff's post-filing purchase of a vehicle could not cure the standing problem). In their Reply brief, defendants focus on *United States for the Use and Benefit of Wulff v. CMA, Inc.*, 890

F.2d 1070, 1074-75 (9th Cir. 1989), a Ninth Circuit case dismissing claims for lack of standing. *Wulff* is distinguishable, however. In *Wulff*, the assignment of claim occurred after the statute of limitations had run, and there was no relation back to the originally-asserted claims. *Id*. Accordingly, the decision in *Wulff* turned on the statute of limitations and the relation-back issues, not on whether a post-filing assignment of claim might save a claim that was otherwise timely asserted.

Defendants do not dispute that Plaintiffs' assignment conferred standing when it was executed; instead, defendants argue that because this assignment occurred after the complaint was filed, it "came too late" to affect Plaintiffs' standing. Mot. at 10. According to this argument, if Northstar had dismissed its original complaint without prejudice and filed a new complaint relying on the assignment of claim, rather than filing an amended complaint, there would be no standing problem now. In that case, standing would have existed at the time the new case was filed. This argument elevates form over substance. Particularly in light of Judge Illston's previous holding that the assignment would cure the Plaintiffs' lack of standing, and direction to the Plaintiffs to file an amended complaint based on the assignment, it would be unfair to Plaintiffs to punish them for relying on the Court's specific instructions. Accordingly, the Court finds that in this particular circumstance, Judge Illston's order will be construed as granting Plaintiffs leave to file a supplemental pleading under Federal Rule of Civil Procedure 15(d).

Although there is no published Ninth Circuit authority on this point, courts in other circuits have found that parties may cure standing deficiencies through supplemental pleadings. *See Perry*, 180 F.R.D. at 337 ("a supplemental complaint may correct deficiencies such as lack of standing."); *Travelers Ins. Co. v. 633 Third Assoc.*, 973 F.2d 82, 87-88 (2d Cir. 1992) (granting plaintiff leave to file a supplemental pleading incorporating events occurring after the complaint was filed in order to establish standing); *Decorative Ctr. of Houston v. Direct Response Publs., Inc.*, 264 F. Supp. 2d 535, 544 n.22 (S.D. Tex. 2003). Accordingly, the Court concludes that Plaintiffs' FAC, filed on March 2, 2009, constituted a supplemental pleading approved by Judge Illston's February 19, 2009 Order under Rule 15(d). This supplemental pleading established Plaintiffs' standing to sue based on the asserted assignment of claim. Therefore, defendants' Motion to Dismiss based on a lack of standing is DENIED.

b. SLUSA Preclusion

Defendants argue that Plaintiffs' claims are precluded by the Securities Litigation Uniform Standards Act of 1998 (SLUSA). 15 U.S.C. § 77p.

SLUSA was enacted to prevent a "shift from Federal to State courts" of lawsuits asserting securities law violations in the wake of the Private Securities Litigation Reform Act of 1995 (PSLRA). *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 82 (2006) (internal citation omitted). In order to avoid the PSLRA's requirements, plaintiffs began asserting what were essentially federal securities law claims as state law causes of action in state court. *Id.* Congress sought to end this practice by amending the Securities Acts of 1933 and 1934 through SLUSA.

SLUSA prohibits class actions brought on behalf of more than 50 people ("covered class actions"), if the action is based on state law and alleges (a) a misrepresentation or omission of a material fact in connection with the purchase or sale of covered security; or (b) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security. 15 U.S.C. §§ 77p, 78bb; *Proctor v. Vishay Intertechnology Inc.*, 584 F.3d 1208, 1221-22 (9th Cir. 2009). The complaint need not allege scienter, reliance, or loss causation in order for SLUSA preclusion to apply. *See Anderson v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 521 F.3d 1278, 1285-87 (10th Cir. 2008). In addition, the precluded state law claims need not contain a "specific element" of misrepresentation in order to be precluded by SLUSA. *Proctor*, 584 F.3d at 1222, n.13.

Plaintiffs concede that this is a “covered class action,” that their claims are based on state law, and that the Fund’s shares are covered securities under SLUSA. Plaintiffs dispute the final two elements of SLUSA preclusion: first, that the SAC alleges misrepresentations or omissions of material fact, and second, that any such misstatements or omissions are alleged to have been made “in connection with” the purchase or sale of the Fund’s shares.

i. Misrepresentations

A careful review of the SAC shows that Plaintiffs allege a number of misrepresentations by defendants. First, Plaintiffs list a number of Registration Statements and Prospectuses in which Schwab represented that the Fund would pursue a “fundamental indexing strategy ‘to track’ [the Lehman Brothers] bond index ‘through the use of an indexing strategy. . . .’” SAC ¶¶ 49 – 79. Plaintiffs allege that defendants repeated these statements in 1997, 1998, 2003, 2004, 2005, 2006, 2007 and 2008. *Id.* According to Plaintiffs, these statements of Fund policy attracted many investors to the Fund: “[t]he Index Fund’s conversion to an indexing strategy was a great success for Schwab, as net assets increased from $24 million as of August 31, 1997 to approximately $1.5 billion as of August 31, 2007.” SAC ¶ 80. Then, in the section of the SAC titled “The Fund Substantially Deviates From Its Stated Investment Objective,” Plaintiffs allege that the Fund began to deviate from its promises to use an indexing strategy to track the Index. Plaintiffs allege that the Fund first reported "a material performance deviation from the Index" in a Semi-Annual Report filed on May 6, 2008. SAC ¶ 95. Plaintiffs allege that investors "could not anticipate from this Report that the Fund would continue to deviate from the Index" because defendants provided an inaccurate explanation for why the deviation had happened. SAC ¶¶ 96-97. Specifically, Plaintiffs allege that defendants blamed the deviation on "the forced selling of securities into a weak bond market" when the real cause of Fund's losses was "the deviation of the securities in the Fund from the Index." *Id*. Finally, Plaintiffs allege that the Fund's deviation from the Index "was caused by the Fund's investment of 27.3% of assets as of February 27, 2008 in non-agency collateralized mortgage obligations" and that "[t]his concentration of investments in mortgage backed securities was . . . in violation of the Fund's stated investment objectives that the Fund's assets not be concentrated more than 25% in any one industry." SAC ¶ 103, 106. Plaintiffs allege that this concentration also violated "the Fund's fundamental investment objective to 'seek to track' the Index 'through the use of an indexing strategy." SAC ¶ 109.

All the asserted claims allege Plaintiffs' reliance on the Fund's fundamental investment objectives. In addition, all of the claims allege that Plaintiffs were harmed due to the failure of the Fund to follow those objectives. For example, in their Breach of Fiduciary Duty claim, Plaintiffs assert that they "relied on" defendants to "adhere to the Fund's investment objectives and policies," and that defendants' failure to do so caused Plaintiffs to "sustain[ ] money damages in connection with their ownership of shares in the Fund." SAC ¶¶ 130, 136. Likewise, in their Breach of Contract claim, Plaintiffs allege that they "retained or purchased shares" of the Fund "in consideration of the contractual obligations not to change fundamental investment objectives . . . ," and that they sustained economic damages when the Fund failed to meet these obligations. SAC ¶ 144, 148. In their claim for Third Party Beneficiary of the Investment Advisory Agreement, Plaintiffs allege that defendants appended the Investment Advisory Agreement to the December 29, 1997 Registration Statement "precisely to inform class members of its terms," and that these terms included a requirement that the Investment Advisor "manage the Fund consistent with the Fund's fundamental investment objectives." SAC ¶ 155-58. In addition, this claim alleges that investors were injured when the Investment Advisor "fail[ed] to manage the Fund's assets in a manner consistent with the Fund's fundamental investment objectives." SAC ¶ 164.

In summary, the central theme of the SAC and all of Plaintiffs' claims is that defendants made misrepresentations about how investments in the Fund would be managed, that Plaintiffs purchased Fund shares relying on these misrepresentations, and that Plaintiffs were injured when these statements turned out to be false. The Court finds that Plaintiffs' claims allege misrepresentations for SLUSA purposes. In making this determination, the Court must focus on the overall gravamen of the complaint; Plaintiffs cannot avoid SLUSA by artful drafting to avoid the term "misrepresentation." *See Proctor*, 584 F.3d at 1221-22; *Tuttle v. Sky Bell Asset Mgmt, LLC*, No. C10-03588, 2010 U.S. Dist. LEXIS 127839 at *9 (N.D. Cal. Nov. 19, 2010); *Stoody-Broser v. Bank of America*, No. C 08-02705, 2009 WL 2707393 at *2 (N.D. Cal. Aug. 25, 2009). Where, as here, the alleged state law claims rely on alleged misrepresentations, this element of SLUSA is met—even if the state law claims do not require any misrepresentation.

For example, the Fifth Circuit found a breach of contract claim precluded by SLUSA, even though the underlying claim required no misrepresentation. *Miller v. Nationwide Life Ins. Co.*, 391 F.3d 698, 702 (5th Cir. 2004), *cited with approval in Proctor*, 584 F.3d at 1222 n.13. Like Plaintiffs in this case, the *Miller* plaintiffs claimed that a contract had been formed based on the terms of a prospectus, which allegedly stated that no trading fees would be imposed. *Miller*, 391 F.3d at 701-02. The plaintiffs claimed the contract was breached when trading fees were imposed despite this term. *Id*. The Fifth Circuit found this claim precluded by SLUSA, because it was based on allegations that Nationwide had made false promises of fee-free trading which were later broken. *Id*. Even though the contract claim did not *require* any allegations of misrepresentation, the plaintiff had in fact alleged misrepresentations in the contract claim, and therefore SLUSA applied. *Id*.

Likewise, in *Tuttle*, Judge Alsup of this district found that state law claims which did not themselves require allegations of misrepresentation were nevertheless precluded by SLUSA. In *Tuttle*, the complaint alleged that "defendants 'assured' plaintiffs that their money would be placed in 'massively diversified investments,'" but that these assurances "assertedly [were] an illusion." *Tuttle*, 2010 U.S. Dist. LEXIS 127839 at *13-14. Judge Alsup concluded that "the essence of the complaint is that defendants misrepresented the manner in which plaintiffs' money was to be invested." *Id*.

In another ruling from this district, Judge White found that state law claims of breach of fiduciary duty brought on behalf of a class of trust beneficiaries (similar to the breach of fiduciary duty claim asserted here) were precluded by SLUSA. *Stoody-Broser*, 2009 WL 2707393 at *3-*4. Despite the fact that the complaint did not directly allege any misrepresentations, the Court found that "the essence of the complaint is that defendants misrepresented and omitted material facts relating to the investment in Columbia Funds, such as conflicts of interest and increased expenses related to the investment. Because federal law comprehensively regulates the purchase and sale of mutual fund shares and requires the disclosure of material information about the fund's objectives, performance, fees and interests of its managers, courts have recognized that state law class action claims that challenge excessive fees and other aspects of mutual fund investments of necessity involve misstatements . . . ." *Stoody-Broser*, 2009 WL 2707393 at *3.

Plaintiffs argue that the statements from the SAC cited above are not properly characterized as misrepresentations, because they were generally true at the time they were made, and only became false or misleading after the beginning of the class period. "Schwab successfully operated the Fund as an index fund for over ten years – from August 31, 1997 until after August 31, 2007." *See* Plaintiffs' Opp'n. to Mot. (Opp'n.) (Dkt. No. 158) at 19. However, this argument does not remove the claims from SLUSA's scope. Even if Plaintiffs now allege the statements were true at some point, the class definition starts the clock for the class claims at the moment Plaintiffs allege the statements became untrue – "from August 31, 2007 through February 27, 2009." At the hearing on this

Motion, Plaintiffs stated that the complained-of deviation from the Index began at the start of the class period, and Plaintiffs' complaint makes clear that at this point, Plaintiffs contend that the defendants' previous representations and assurances about the Fund became untrue. Although Plaintiffs allege that defendants disclosed a change in concentration policy in 2007, Plaintiffs also allege that defendants provided false reasons for why the Fund subsequently deviated from the Index in a May 6, 2008 Semi-Annual Report. SAC ¶¶ 111, 95-97. Moreover, the SAC alleges that defendants continued to make misrepresentations about the Fund's investment policy during the class period. Consequently, contrary to Plaintiffs' argument at the hearing, removal of the May 6, 2008 Semi-Annual Report false explanation would not save the claims from SLUSA preclusion, because Plaintiffs have claimed many misrepresentations throughout the SAC and within each of their claims.

The authority Plaintiffs cite is distinguishable. Plaintiffs argue that the Ninth Circuit has held that state-law contract claims are not precluded by SLUSA, but Plaintiffs fail to acknowledge that the question turns on whether or not the contract claim implicates a misstatement or omission made in connection with the purchase of a security. Plaintiffs rely on a non-precedential Ninth Circuit opinion for this supposed distinction between "fraud and nonfraud claims." Opp'n. at 19. *Beckett v. Mellon Investor Servs. LLC*, 329 F. App'x 721, 723-24 (9th Cir. 2009). In fact, *Beckett* held that it was error to dismiss without leave to amend where contract claims might have been stated based on an investment firm's failure to sell shares in a timely manner, and where the plaintiff alleged no "statements regarding these actions or that some material fact relating to them was omitted." *Id.* Because such claims had no relationship to any alleged misrepresentations, they were not precluded by SLUSA. Likewise, in *Falkowski v. Imation Corp.*, No. 01-16113, 2002 U.S. App. LEXIS 28037 at *16-17 (9th Cir. Oct. 29, 2002), the Ninth Circuit held that breach of contract claims based on employee stock-option contracts were not precluded by SLUSA. *Id.* Contrary to Plaintiffs' reading, this was not simply because the claims were breach of contract claims, but because these claims did not relate in any way to the allegations of misrepresentation that resulted in preclusion of other asserted claims. The breach of contract claims asserted that employees' employment status had been wrongfully terminated. This claim was totally independent from claims that the defendant had inflated the value of its stock by concealing information about an impending accounting write-off. *Id.*

Finally, Plaintiffs rely on another Judge Alsup decision, and urge that the "exact issue" presented here was addressed in that case. *In re*

*Charles Schwab Corp. Secs. Litig.*, 257 F.R.D. 534, 551 (N.D. Cal. 2009) (finding a claim of breach of fiduciary duty not precluded by SLUSA). However, Judge Alsup himself distinguished the *Charles Schwab* decision in *Tuttle*. The fiduciary duty claim in *Charles Schwab* was not based on any misrepresentations because the "plaintiffs readily agreed that defendant properly disclosed the change in its concentration policy but argued that the change was nevertheless improper." *Tuttle*, 2010 U.S. Dist. LEXIS 127839 at *15. In contrast, here, the Plaintiffs allege that although defendants reported the Fund's change in concentration policy and its deviation from the Index, they covered up the true reason for this deviation by providing a false explanation in the May 6, 2008 Semi-Annual Report. SAC ¶¶ 96-97. The Ninth Circuit has held that "[m]isrepresentation need not be a specific element of the claim to fall within [SLUSA's] preclusion," and has cited other appellate decisions finding breach of contract claims precluded by SLUSA. *Proctor*, 584 F.3d at 1222 n.13, citing *Miller*, 391 F.3d at 701-02.

In this case, the asserted misrepresentations are the basis for all of Plaintiffs' claims as currently pled. Thus, the Court concludes that this element of SLUSA preclusion is met.

ii. In Connection With

Although Plaintiffs' main argument against SLUSA preclusion is that there are no alleged misrepresentations, Plaintiffs also contend that the "in connection with the purchase or sale of a covered security" element of SLUSA preclusion is not met. Plaintiffs assert almost no support for this position, and there is little to be found. The Supreme Court has adopted a broad construction of "in connection with." *See Dabit*, 547 U.S. at 86. The alleged misrepresentation need only "'coincide' with a security transaction—whether by the plaintiff or by someone else." *Dabit*, 547 U.S. at 85. Thus, the Supreme Court has found that SLUSA precludes "holder" claims, where the plaintiff alleges harm based on "wrongfully-induced holding." Plaintiffs who purchased stock "before any relevant misrepresentation," and were only injured by not later selling the stock due to alleged misrepresentations, meet the SLUSA "in connection with" requirement. *Dabit*, 547 U.S. at 76, 78.

Here, the claimed class period is defined as the time during which the Fund deviated from the Index. Plaintiffs define the class as anyone who owned or purchased shares of the Fund during this time. Plaintiffs further allege that during this time, defendants' many statements about the Fund tracking the Index were not true, because defendants impermissibly concentrated the Fund's assets in non-governmental CMOs. Plaintiffs further allege that defendants provided a false explanation for the initial deviation of the Fund from the Index, such that Plaintiffs "could not have anticipated" that further deviations would occur. SAC ¶¶ 96-97. Overall, there is no question that Plaintiffs' allegations arise "in connection with" the purchase or sale of covered securities, as required by SLUSA. The Supreme Court has explained that SLUSA preclusion is to be given a broad construction, in part, because it does not entirely prevent state law claims from being brought. "SLUSA does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class-action device to vindicate certain claims. The Act does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist." *Dabit*, 547 U.S. at 87.

iii. Delaware carve-out

Finally, regarding the breach of fiduciary duty claim, Plaintiffs belatedly argued (in a submission of additional authority filed after the hearing on this Motion) that if the Court applied Massachusetts law to this claim, SLUSA should not apply pursuant to the "Delaware carve-out." This provision of SLUSA states that, notwithstanding the preclusion provision, "a covered class action . . . that is based upon the statutory or common law of the State in which the issuer is . . . organized (in the case of any other entity) may be maintained in a State or

Federal court by a private party." 15 U.S.C. 77(p)(d)(1)(a). The Plaintiffs state in the SAC that the fiduciary duty claim is "asserted under California law" but that it is "viable under Massachusetts law as well." SAC ¶ 121. To the extent Plaintiffs rely on California law to establish their claim, the claim is precluded by SLUSA. To the extent Plaintiffs rely on Massachusetts law, the claim is not precluded.

Plaintiffs' other claims (breach of contract, breach of the covenant of good faith and fair dealing, and third party beneficiary claims) appear to be based exclusively on California law, as Plaintiffs have primarily cited cases interpreting California law (and no Massachusetts law cases) in arguing against their dismissal. Plaintiffs' failure to argue that the carve-out should apply to any other claim is further support for this conclusion. Thus, no other claim is affected by the Delaware carve-out.

Accordingly, the Court finds that as pled, all of Plaintiffs' claims, with the exception of the breach of fiduciary duty claim to the extent it is premised exclusively on Massachusetts law, are precluded by SLUSA. The claims are therefore DISMISSED. Because Plaintiffs could conceivably amend their pleadings to avoid SLUSA preclusion, the Court grants leave to amend. *See Knappenberger v. City of Phoenix*, 566 F.3d 936, 942 (9th Cir. 2009). Plaintiffs are given leave to amend as outlined in this Order.[3]

The Court will now analyze the sufficiency of each of Plaintiffs' claims separate from the SLUSA preclusion issue.

c. Contract Claim

In the SAC, Plaintiffs allege that a contract was formed between Fund investors and the Trust. Plaintiffs allege that a July 25, 1997 Proxy Statement (the 1997 Proxy Statement) proposed changes to the fundamental investment objective of the Fund, and "formed the terms of a contract to provide shareholders with voting rights in that those 'fundamental investment objectives' were only changeable by shareholder vote." SAC ¶ 52. Plaintiffs allege that the contract was formed when Plaintiffs held or purchased shares of the Fund. SAC ¶ 145.

Defendants argue that Plaintiffs have not sufficiently alleged the formation of an enforceable contract. Defendants cite two Ninth Circuit decisions holding that statements in prospectuses do not automatically become contract terms. *See McKesson v. HBOC, Inc. v. New York State Common Ret. Fund, Inc.*, 339 F.3d 1087, 1092-93 (9th Cir. 2003); *Cohen v. Stratosphere Corp.*, 115 F.3d 695 (9th Cir. 1997).

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[3] Defendants raised the SLUSA preclusion issue for the first time in the instant motion to dismiss.

Although Judge Illston previously noted that these cases do not broadly hold that a prospectus can never be a contract, as defendants point out, these cases do apply traditional contract law concepts such as offer, acceptance, and consideration in evaluating claims that securities disclosure documents are contracts.

For example, when evaluating the alleged contract in *McKesson*, the Ninth Circuit found that there was no contract between shareholders and McKesson based on a prospectus that solicited shareholder votes to approve a merger between McKesson and HBOC. *McKesson*, 339 F.3d at 1092. First, the Ninth Circuit found that shareholders were not parties to the merger agreement itself. *Id*. Next, it found that although shareholders were asked to vote on the proposed merger, and were told that the merger could not proceed without shareholder approval, nothing in the solicitation of shareholder votes constituted a contractual offer to be accepted, and distinguished securities offers from contractual offers. *Id*. The Ninth Circuit found that simply voting on the proposed merger did not constitute "acceptance" in the contractual sense. *Id*. Finally, the court distinguished tender offers, which can constitute contractual offers (to be accepted by a tender of shares). *Id*., 339 F.3d at 1092-93. Likewise, in *Cohen*, the Ninth Circuit found that the prospectus could not be an offer because, by its own terms, it did not make a "firm commitment" on the part of the alleged offeror. *Cohen*, 115 F.3d at 701. The prospectus was properly viewed as a solicitation of offers, and because these offers were never accepted, no contract was formed. *Id*. "The mutual assent and intent to be bound that are required for the formation of a contract to sell securities, therefore, is absent in this case." *Id*.

Perhaps mindful of this authority, which was previously cited by defendants, Judge Illston specifically ordered the Plaintiffs to "add more specific allegations regarding the language plaintiff relies on to allege the formation of a contract, as well as each defendant's involvement." Feb. 19, 2009 at 15. Plaintiffs responded by simply asserting that the 1997 Proxy Statement formed a contract between Fund investors and the Trust. Plaintiffs do not argue that shareholders accepted an offer by voting on the 1997 Proxy Statement (and, in light of the Ninth Circuit's guidance in *McKesson*, this is probably not a viable argument). Instead, Plaintiffs argue that they accepted the offer of the proposals in the 1997 Proxy Statement by providing the consideration of purchasing or retaining shares (presumably during or before the class period, which began ten years after the 1997 Proxy Statement, in 2007). Opp'n. at 5; SAC at ¶¶ 144-145. Plaintiffs appear to argue that after the 1997 Proxy Statement was approved by shareholders and redefined the fundamental investment objective of the Fund, future shareholders "accepted" the offer of a mutual fund operated in accordance with these objectives by purchasing or holding shares. Although Plaintiffs identify the 1997 Proxy Statement as supplying the terms of the offer, they also reference and rely upon defendants' repetition of these terms in various other SEC-required disclosure documents. See SAC ¶¶ 71-94.

Relying on *McKesson*, Judge Alsup rejected an almost-identical argument in another class-action litigation brought by holders of Charles Schwab mutual fund shares. *In re Charles Schwab Corp. Sec. Litig.*, No. C 08-01510, 2009 U.S. Dist. LEXIS 44859 at *9-10 (N.D. Cal. May 15, 2009). As Judge Alsup explained, "[P]laintiffs contend that when each investor purchased shares of the fund, the investor entered a contract with the fund and each of its trustees. The contract allegedly included not only the sale of fund shares but also each and every term of the registration statements and SAIs . . . [t]he alleged breach occurred when defendants changed this no-concentration policy by redefining the term 'industry' to permit greater investment in mortgage-backed securities, *without a shareholder vote*." *Id.* (emphasis in original). Judge Alsup concluded that plaintiffs had not successfully pled the formation of a contract. Plaintiffs offered "no coherent theory" explaining how the various SEC filings had been incorporated into a contract, and rejected

Plaintiffs' argument that they were accepted by plaintiffs' purchase of the funds. *Id.* at *13.

The Court finds the *In re Charles Schwab* decision persuasive, and concludes that Plaintiffs have failed to successfully allege the formation of a contract. If Plaintiffs are correct that each SEC-required disclosure statement issued regarding the Fund was incorporated into an evolving contract between the Trust and investors, the fact that a September 1, 2006 Statement of Additional Information was issued which stated that the Fund would, from then on, cease to treat "mortgage-backed securities issued by private lenders" as a separate industry and therefore could invest more than 25% of the Fund's assets in this area would seem to defeat Plaintiffs' contract claim. If this became a term of the contract between Plaintiffs and the Trust when investors held or subsequently purchased shares, then the Trust could not have breached this contract by over-investing in MBS, as Plaintiffs claim.

Plaintiffs have not cited any persuasive authority finding that a contract was formed in even remotely similar factual circumstances. In *Mills v. Polar Molecular Corp.*, 12 F.3d 1170 (2nd Cir. 1993), the plaintiff and his employer signed a settlement agreement whereby the plaintiff agreed to dismiss claims in exchange for the employer's promise to register shares of stock issued to the plaintiff. *Mills*, 12 F.3d at 1173-74.

The plaintiff alleged that the employer failed to do so, and the Second Circuit found that this "may have stated a claim" against the employer. However, there was no question that the settlement agreement was a contract. *Mills*, 12 F.3d at 1177. Likewise, in *In re Gulf Oil*, 725 F.Supp. 712 (S.D.N.Y. 1989), the court found that a tender offer to shareholders created a contract when shareholders accepted it by tendering shares. *In re Gulf Oil* 725 F.Supp. at 728. But, this is not very helpful because, as described above, the Ninth Circuit has distinguished the "tender offer" line of cases in finding no contract in *McKesson*. In a tender offer situation, there is a clear offer (the offer to purchase shares) and acceptance (tendering of the shares). Plaintiffs have alleged no such straightforward theory of contract formation here. Finally, Plaintiffs cite *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 605 (S.D. Ill. 1978). In this case, the Southern District of Illinois found that redemption provisions in a prospectus issued with preferred stock constituted binding contract terms, which shareholders accepted by purchasing the stock. As defendants point out, in so holding, the court noted that "[i]t is unquestioned that the redemption terms of preferred stock issues create a contract between the corporation and its stockholders." *Id.*, 451 F. Supp. 602 at 613; *accord, D.E. Shaw Laminar Portfolios, LLC v. Archon Corp.*, No. 2:07-CV-

01146, 2010 U.S. Dist. LEXIS 135867 at *6-8 (D. Nev. Dec. 22, 2010).

Judge Illston specifically charged Plaintiffs to "add more specific allegations regarding the language plaintiff relies on to allege the formation of a contract, as well as each defendants' involvement." Plaintiffs have failed to persuade the Court that a contract was formed based on the 1997 Proxy Statement or the other disclosure documents referenced in the SAC. Because Plaintiffs were previously given leave to amend this claim and have failed to state a claim, their breach of contract claim is dismissed WITH PREJUDICE.

d. Breach of Covenant of Good Faith and Fair Dealing Claim

The covenant of good faith and fair dealing is an implied term of a contract. *Smith v. City and County of San Francisco*, 225 Cal. App. 3d 38, 49 (1990). Without a valid contract, there can be no implied term. *Id.* Because the Court has concluded that the Plaintiffs have failed to allege the existence of any valid contract, the claim for breach of the implied covenant must fail as well. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 690 (1988). Because the Court has dismissed Plaintiffs' contract claim with prejudice, no amendment can save the implied covenant claim. Accordingly, Plaintiffs' Breach of Covenant of

Good Faith and Fair Dealing claim is DISMISSED WITH PREJUDICE.

e. Fiduciary Duty Claim

At the hearing on this Motion, Plaintiffs agreed with defendants' argument that because the Trust is organized under Massachusetts law, Massachusetts law applies in determining whether or not a claim is derivative. Interpreting Massachusetts law, the Ninth Circuit has previously found that injuries affecting all trust shareholders equally are derivative in nature. *Lapidus v. Hecht*, 232 F.3d 679, 683 (9th Cir. 2000). Derivative claims must be asserted through a shareholder derivative action, including compliance with the demand-futility requirement of Federal Rule of Civil Procedure 23.1. Defendants argue that Plaintiffs' claims "do not allege any direct injury to investors in the fund . . . [b]ecause Northstar seeks money damages arising from the way the fund was managed, its claims are derivative and must be pleaded in compliance with Rule 23.1." Mot. at 5. However, in *Lapidus*, the Ninth Circuit also held that a claim for violation of contractual shareholder voting rights "satisf[ies] the injury requirement for a direct action under Massachusetts law" and confers standing to pursue individual claims. *Lapidus*, 232 F.3d at 683. In the SAC, the Plaintiffs allege that defendants breached their fiduciary duties to Plaintiffs by failing "to require a majority shareholder vote prior to deviating from the Fund's stated fundamental investment objectives." SAC ¶ 134. The Plaintiffs repeat the denial-of-voting-rights allegation throughout the SAC and the claim for breach of fiduciary duty. Therefore, at first blush, it might appear that Plaintiffs have sufficiently stated a direct injury under Massachusetts law, because they claim that defendants violated Plaintiffs' contractual voting rights.

However, as discussed above, the Court has found that the Plaintiffs have failed to state a claim for breach of contract, because they have not successfully alleged the formation of a contract. The only other asserted basis for Plaintiffs' alleged voting rights in the SAC is the ICA. However, Plaintiffs cannot directly assert a violation of the ICA regarding voting rights. Northstar, 615 F.3d at 1122. Accordingly, it is not clear that the Plaintiffs can assert a violation of voting rights under the ICA as the basis for a fiduciary duty breach. If Plaintiffs' fiduciary duty claim were read without reference to voting rights, it would seem that the asserted harm affects all shareholders equally, and is therefore derivative. "A shareholder does not acquire standing to maintain a direct action when the alleged injury is inflicted on the corporation and the only injury to the shareholder is the indirect harm which consists of the diminution in the value of his or her shares." *Lapidus*, 232 F.3d at 683.

Plaintiffs cite *Strigliabotti v. Franklin Resources, Inc.*, No. C 04-00883 SI, 2005 WL 645529 at *7-8 (N.D. Cal. Mar. 7, 2005) for the proposition that because of the difference between a corporation's stock and mutual fund shares, "no value can be attributed to a derivative claim" against a mutual fund, and even a diminution in value claim should be considered individual. Opp'n. at 23. This case is distinguishable on several grounds. First, it was interpreting California, not Massachusetts law. *Strigliabotti*, 2005 WL 645529 at *23-24. Second, the harm alleged in *Strigliabotti* related to fees charged directly to investors (rather than to a diminution in share value). Id. at *25.

Until Plaintiffs have stated a claim for breach of fiduciary duty that does not implicate SLUSA and that is not derivative, the Court finds it unnecessary to determine whether or not any of the named defendants potentially owed a fiduciary duty to Plaintiffs, although the Court notes (as Judge Illston previously noted) defendants' previous admission that they did "not argue that no person or entity owes a fiduciary duty to the Fund's investors." Feb. 19, 2009 Order at 14-15; *see Everett v. Bozic*, No. 05 Civ. 00296(DAB), 2006 WL 2291083 at *4 (S.D.N.Y. Aug. 3, 2006) (dismissing fiduciary duty claims predicated on diminution of value in a mutual fund as derivative without deciding "whether such a direct [fiduciary] duty exists or not.").

f. Third Party Beneficiary of the Investment Advisor Agreement

Plaintiffs' fourth claim is for breach of the Investment Advisor Agreement between the Investment Advisor and the Trust. Plaintiffs claim that they were third party beneficiaries to this agreement. In support of this claim, Plaintiffs allege that the Investment Advisor was required to "manage the Fund consistent with the Fund's fundamental investment objectives and policies." SAC ¶ 155. Specifically, Plaintiffs claim that the Investment Advisor Agreement required the Investment Advisor to determine "what securities and other investments will be purchased, retained or sold" by the Fund, to prepare shareholder reports and required disclosures to the SEC, maintain records about the Fund, and comply with all SEC rules. SAC ¶ 156. The Plaintiffs further allege that the Investment Advisor Agreement required the Investment Advisor to manage the fund "in accordance with the Fund's fundamental investment objectives and policies." SAC ¶ 157. The Plaintiffs did not append a copy of the Investment Advisor Agreement to the SAC, but the defendants have submitted a copy and requested judicial notice of it, and the Plaintiffs have subsequently cited and relied on this submission in briefing. *See* Calia Decl. ISO Mot., Ex. D. The Court may take judicial notice of documents which are referenced in but not appended to the pleadings, and whose authenticity no party disputes. *Branch v. Tunnell*, 14 F.3d 449, 454 (9th Cir. 1994) (overruled on other grounds by *Galbraith v. County of Santa Clara*, 307 F.3d 1119 (9th Cir. 2002). Accordingly, defendants' request for judicial notice of the Investment Advisor Agreement is granted.

Defendants argue that because the Investment Advisor Agreement itself does not "explicitly, directly, definitely or in unmistakable terms" state the intent to benefit the Fund's investors, Plaintiffs cannot establish third party beneficiary status. *Smith v. Microskills San Diego L.P.*, 153 Cal. App. 4th 892, 898 (2007). Under California law, a contract must be clear in its *intention* to benefit a third party in order for that party to establish beneficiary status. *Id.*; Cal. Civil Code § 1559 ("a contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it."). "[T]he third person need not be named or identified individually to be an express beneficiary." *Kaiser Eng'rs v. Grinnell Fire Prot. Sys. Co.*, 173 Cal. App. 3d 1050, 1055 (1985) (internal citations omitted). Rather, it is the intention of the contracting parties that must expressly seek to benefit the third party.

There are several ways to show that a third party is an intended beneficiary of a contract even if he is not specifically named in the contract. One is to show that the contract expressly names a class of beneficiaries, and that the plaintiff belongs to the class. *See, e.g., Kaiser Eng'rs* 173 Cal. App. 3d at 1055. "While the beneficiary need not be named in the contract, he must be a member of a class referred to and identifiable therein." *Kirst v. Silna*, 103 Cal. App. 3d 759, 763 (1980). Alternatively, a non-party may be a beneficiary to a contract that does not name the party if that contract discharges a separate contractual duty owed to the non-party. *See Gilbert Financial Corp. v. Steelform Contracting Co.*, 82 Cal. App. 3d 65, 70 (1978). In sum, Civil Code Section 1559 "excludes enforcement of a contract by persons who are only incidentally or remotely benefited by it." *Kaiser*, 173 Cal. App. 3d at 1055.

If a contract does not clearly evince the intent to benefit a third party, that party is not a beneficiary of the contract. For example, a treating physician is generally not considered an intended beneficiary to a contract between a health care service provider and a patient, even if the contract could result in payments to the physician. *Ochs v. PacifiCare of California*, 115 Cal. App. 4th 782, 795 (2004) ("Generally speaking, a health care service provider's agreement to pay for medical care is intended to benefit the enrollees, not treating physicians with whom there is no contractual relationship."). Even though the treating physicians might be entitled to payments through the health service provider, and therefore could incidentally benefit from the service contract, the *intent* of the contract is to benefit enrollees, not treating physicians, and therefore treating physicians are not third party beneficiaries. *Ochs*, 115 Cal. App. 4th at 795. Defendants argue that the investors are like these treating physicians, only incidentally benefiting from the Investment Advisor Agreement. The Court is not persuaded, based on the present record, that Plaintiffs' third party beneficiary claim is as remote as defendants claim. The Plaintiffs allege that the Agreement required the Investment Advisor to manage the investments of the Fund, prepare regular reports to shareholders and the SEC, keep records, and comply with SEC rules. The value of Plaintiffs' investments in the Fund would change directly depending on the Investment Advisor's management of the Fund.

The authorities cited by Plaintiffs are not particularly helpful, because these cases discuss contracts that expressly name a class of beneficiaries, where the plaintiffs alleged that they were class members. For example, in *Spinks v. Equity Residential Briarwood Apartments*, 171 Cal. App. 4th 1004, 1021 (2009), the court found that there was a triable issue as to whether an apartment lease agreement between an employer and the owner of the apartment intended the employee, who was residing in the apartment while she worked away from home, as a beneficiary. Even though the employee was not directly named in the lease, the lease agreement identified the employer's "temporary staff" as beneficiaries, and the plaintiff belonged to the class of temporary staff. In addition, the employee introduced a lease extension letter which expressly identified her as a beneficiary. Thus, the appellate court found that there was a triable issue as to whether the employee was a third party beneficiary to the lease agreement. Likewise, in *County of Santa Clara v. Astra USA*, 588 F.3d 1237, 1243-45 (9th Cir. 2009), the Ninth Circuit found that federally-funded health clinics were third-party beneficiaries of a contract between the federal government and drug manufacturers. However, this finding was based on express language in the contract that prohibited drug manufacturers from over-charging "covered entities" for drugs. Astra USA, 588 F.3d at 1243-45 (interpreting federal common law). As in *Spinks*, the plaintiffs were third party beneficiaries because they were in the class of express beneficiaries named in the contract. These cases are not helpful to Plaintiffs because they cannot point to any language in the Investment Advisor Agreement identifying a beneficiary class to which they belong.

The Court has already concluded that Plaintiffs' breach of contract claim based on the Investment Advisor Agreement, as currently pled, is precluded by SLUSA. Given that the parties devoted limited briefing to the question of whether Plaintiffs can qualify as third party beneficiaries, and that the Court has not found this briefing particularly helpful, the Court declines to decide now whether or not the Investment Advisor Agreement can provide a basis for such a claim. Plaintiffs are hereby given leave to amend their complaint to re-assert this claim without triggering SLUSA preclusion, if they can. In addition to avoiding SLUSA preclusion, Plaintiffs are directed to specify in any amended complaint what specific provisions of the Investment Advisor Agreement were allegedly breached, and how.

IV. Conclusion

The Court finds that, as currently pled, all of Plaintiffs' claims, except Plaintiffs' breach of fiduciary duty claim if it is based exclusively on Massachusetts law, are precluded by SLUSA. Despite having been given leave to amend, Plaintiffs have failed to state a claim for breach of contract or breach of the implied covenant of good faith and fair dealing; these claims are DISMISSED WITH PREJUDICE. Plaintiffs' claims for breach of fiduciary duty and third-party beneficiary are DISMISSED WITH LEAVE TO AMEND as specified in this Order. In order to avoid SLUSA, Plaintiffs must plead claims that are wholly distinct from any allegations of misrepresentation, as held in *Proctor*. *Proctor*, 584 F.3d at 1221-22. If Plaintiffs are unable to resolve the issues discussed herein, these claims will be dismissed with prejudice. Plaintiffs shall file any Third Amended Complaint by **March 22, 2011**.

**IT IS SO ORDERED.**

Dated: March 2, 2011

LUCY H. KOH
United States District Judge

## APPENDIX C – OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT DECIDED AUGUST 12, 2010

## UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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| NORTHSTAR FINANCIAL ADVISORS INC.,<br>*Plaintiff-Appellee*,<br>v.<br>SCHWAB INVESTMENTS; CHARLES SCHWAB INVESTMENT MANAGEMENT, INC.,<br>*Defendants-Appellants*. | No. 09-16347<br>**D.C. No. 3:08-cv-04119-SI**<br>**OPINION** |

*Appendix C*

Appeal from the United States District Court
for the Northern District of California
Susan Illston, District Judge, Presiding

Argued and Submitted
April 12, 2010—San Francisco, California

Filed August 12, 2010

Before: Mary M. Schroeder and N. Randy Smith, Circuit Judges, and James Maxwell Moody, District Judge.*

Opinion by Judge Schroeder

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COUNSEL

Marc J. Gross, Roseland, New Jersey, for plaintiff-appellee Northstar Financial Advisors, Inc.

Darryl P. Rains, Palo Alto, California, for defendants-appellants Schwab Investments, et al.

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* The Honorable James Maxwell Moody, Senior United States District Judge for the District of Arkansas, sitting by designation.

## OPINION

SCHROEDER, Circuit Judge:

The issue we must decide in this appeal is whether there is a private cause of action to enforce the provisions of § 13(a) of the Investment Company Act of 1940 (“ICA” or “1940 Act”), 15 U.S.C. § 80a-13(a). That section 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”).

Our circuit has not decided the issue, but the Second Circuit has held that there is no private right to enforce five other sections of the ICA, reasoning in relevant part that the purpose and structure of the entire Act is grounded upon enforcement by the SEC, not on private enforcement. *See Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 116 (2d Cir. 2007) (per curiam); *Olmsted v. Pruco Life Ins. Co. of New Jersey*, 283 F.3d 429, 433 (2d Cir. 2002). The district court, however, held in a published opinion that Congress did intend private enforcement of § 13(a), citing language in the Sudan Accountability and Divestment Act of 2007 (“SADA”), Pub. L. No. 110-174, 121 Stat. 2516 (2007), that bars suits against investment companies and their advisors for divesting from companies that do business in Sudan. *Northstar Fin. Advisors, Inc. v. Schwab Inv.*, 609 F. Supp. 2d 938, 944-45 (N.D. Cal. 2009). The district court then certified its decision for interlocutory appeal.

We now reverse and hold that nothing in § 13(a) as originally enacted or as subsequently amended either creates a private cause of action or recognizes one exists with the clarity and specificity required under Supreme Court precedent. We are unable to agree with the district court that the SADA's bar to particular litigation on account of the Sudanese emergency is sufficient to constitute recognition of a preexisting private right of enforcement that is not otherwise evident in the language or structure of the ICA.

We explain our conclusion by first tracing the statutory background of the ICA, then discussing the impetus for the legislation, and finally analyzing the issues as required under Supreme Court law. We conclude that the Court has come to require increasingly specific congressional direction for the allowance of private suits to enforce public laws, and no such direction is present in this statute.

## STATUTORY BACKGROUND

### I. The Original Act

Congress enacted the ICA in 1940 to provide comprehensive regulation of investment companies and the mutual fund industry. *See* H.R. Rep. No. 76-2639, at 5 (1940); S. Rep. No. 76-1775, at 1 (1940). The ICA was the outgrowth of an extensive study and investigation of investment trusts and investment companies conducted by the SEC in the late 1930s. *See* S. Rep. No. 76-1775, at 1. Widespread fraud and mismanagement in the mutual fund industry had caused shareholder losses of more than $1 billion that decade. *See* H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 Ann. Rev. Banking & Fin. L. 777, 780-81 (2004). Accordingly, Congress sought to "address problems including self-dealing and breaches of fiduciary duties by fund managers, directors, and affiliates, misappropriation of fund assets, and misrepresentations to investors" that had plagued the mutual fund industry. *Id.* at 781 (footnotes omitted); *see also* 15 U.S.C. § 80a-1(b).

The ICA was the counterpart in the area of mutual fund regulation to the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively, "the 1933 and 1934 Acts"), which were designed to regulate corporate securities. Like the 1933 and 1934 Acts, the ICA requires registration with the SEC and imposes specific reporting requirements. *See* 15 U.S.C. §§ 80a-8, 80a-29. Section 8 of the ICA states that once an investment company registers with the SEC, it must file a registration statement that contains a recital of certain types of investment policies adopted by the company, including the company's policy with respect to concentration of investments in a particular industry or group of industries; any policy that is only changeable through a shareholder vote; and any policy the company deems "fundamental." 15 U.S.C. § 80a-8(b). Section 30 of the ICA states that investment companies must file annual reports with the SEC, and that they must transmit financial reports to shareholders on at least a semi-annual basis. 15 U.S.C. § 80a-29(a), (e).

The ICA, however, created a broader regulatory framework for investment companies than the 1933 and 1934 Acts created for corporate securities. *See* 6 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 20.6 (6th ed. 2009). As one commentator has observed, "a significant focus of the [ICA] is corporate governance and other substantive requirements for investment companies and affiliated entities," which "is in stark comparison to Congress's focus on registration and disclosure" in the 1933 and 1934 Acts. Knickle, *supra*, 23 Ann. Rev. Banking & Fin. L. at 781. This is reflected in the legislative history, where the Senate Report stated that the 1933 and 1934 Acts "ha[d] been ineffective to correct abuses and deficiencies in investment companies." S. Rep. No. 76-1775, at 11. As one means of correcting these abuses and deficiencies, § 13 of the ICA prohibits investment companies from changing certain investment policies included in their registration statements without first obtaining shareholder approval. Subsection (a) states:

> (a) 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.

15 U.S.C. § 80a-13(a).

To ensure compliance with the requirements of the ICA, Congress gave the SEC broad authority to police violations of the Act. Section 42(a) of the ICA states that the SEC

> may make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of [the ICA] or of any rule, regulation, or order hereunder, or to determine whether any action in any court or any proceeding before the [SEC] shall be instituted under [the ICA] against a particular person or persons, or with respect to a particular transaction or transactions.

15 U.S.C. § 80a-41(a). Section 42(d) and (e) authorize the SEC to initiate actions in federal court for injunctive relief or civil penalties against any person or entity the Commission suspects of violating the ICA. *See* 15 U.S.C. § 80a-41(d)-(e). Additionally, Congress granted the

SEC discretion to make exemptions consistent with public interest and policy. Section 6(c) of the ICA states that the Commission

> may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the ICA] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the ICA].

15 U.S.C. § 80a-6(c).

Only one section of the ICA as originally enacted authorized anyone other than the SEC to sue for violations of the Act. Section 30(f) of the 1940 Act incorporated a remedy under the 1934 Act. The section subjected officers, directors, advisory board members, investment advisors, and affiliates of closed-end investment companies, as well as all beneficial owners of ten percent or more of the company's securities, to "the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities." Pub. L. No. 76-768,

§ 30(f), 54 Stat. 789, 837 (1940) (now codified at 15 U.S.C. § 80a-29(h)). Section 16(b) of the 1934 Act states that those individuals subject to its requirements may be sued “at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer” to recover short-swing profits realized by a regulated individual. 15 U.S.C. § 78 p(b). The Supreme Court has said that by incorporating the provisions of § 16(b) of the 1934 Act into § 30(f) of the ICA, Congress expressly authorized private suits for damages against closed-end investment company insiders who make short-swing profits. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 20 & n.10 (1979). There was no other authorization for private suits in the original Act of 1940.

**II. 1970 Amendments**

Congress did not make any major amendments to the ICA until 1970. *See* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970). Those amendments included relatively minor changes to §§ 8 and 13. *See id.* §§ 2(b), 3(c), & 3(d), 84 Stat. at 1414, 1415. The original § 8(b)(2) of the ICA required an investment company’s registration statement to contain a recital of all investment policies “which the registrant deems matters of fundamental policy.” Pub. L. No. 76-768, § 8(b)(2), 54 Stat. at 804 (now codified as amended at 15 U.S.C. § 80a-8(b)(3)). The 1970 amendments added the requirement that a company's registration statement also contain a recital of all investment polices "which are changeable only if authorized by shareholder vote." Pub. L. No. 91-547, § 3(c)(1), 84 Stat. at 1415 (codified at 15 U.S.C. § 80a-8(b)(2)). In a corresponding amendment, Congress supplemented the language in § 13(a)(3), which originally said an investment company could not, without shareholder approval, "deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, or deviate from any fundamental policy recited in its registration statement." Pub. L. No. 76-768, § 13(a)(3), 54 Stat. at 811. The 1970 amendment added a limitation barring an investment company from deviating, without shareholder approval, "from any investment policy which is changeable only if authorized by shareholder vote." Pub. L. No. 91-547, § 3(d), 84 Stat. at 1415 (codified at 15 U.S.C. § 80a-13(a)(3)).

Congress made these changes to §§ 8 and 13 to clarify that an investment company violates § 13(a) whenever it deviates, without shareholder approval, from an investment policy that its registration statement says is changeable only by shareholder vote, even if the registration statement does not also identify the policy as "fundamental." *See* H.R. Rep. No. 91-1382, at 19

(1970). Both Congress and the SEC agreed this amendment was necessary in light of a federal district court's ruling that an investment company must label an investment policy as "fundamental" in its registration statement before the company could be held liable under § 13(a) for deviating from the policy, even if the company's registration statement said that the policy could not be changed without shareholder approval. *Id.* (citing *Green v. Brown*, 276 F. Supp. 753 (S.D.N.Y. 1967), *rev'd*, 398 F.2d 1006 (2d Cir. 1968)). Congress wanted to prevent any further confusion. *Id.*

The 1970 amendments to the ICA also included changes to § 36, which deals with actions for breach of fiduciary duty. Because mutual funds are usually managed by separately owned and operated investment advisors rather than by the investment companies themselves, Congress added § 36(b), which imposed an explicit fiduciary duty on a fund's investment advisor with respect to the management fees it receives. Pub. L. 91-547, § 20, 84 *Stat.* at 1429 (codified at 15 U.S.C. § 80a-35(b)); H.R. Rep. No. 91-1382, at 7; S. Rep. No. 91-184, at 5-6 (1969). Section 36(b) also authorized the security holders of a registered investment company to bring a derivative suit against the company's investment advisor and its affiliates for breach of that duty. 15 U.S.C. § 80a-35(b).

## III. Sudan Accountability and Divestment Act of 2007

The amendments to the ICA with which we are principally concerned in this appeal came in 2007 in response to the crisis in Darfur, Sudan. That year, Congress imposed economic sanctions on two Sudanese government officials and thirty-one Sudanese companies as a result of their involvement with the genocide in Darfur. S. Rep. No. 110-213, at 2 (2007). Those sanctions barred the subject companies from doing business within the United States financial system or with United States companies, and prohibited United States citizens from doing business with the Sudanese companies. *Id.* In addition to the sanctions imposed by the federal government, several states "enacted measures restricting their agencies' economic transactions with firms that do business with, or in, Sudan." *Id.* They were joined in their efforts by "many colleges and universities, large cities, non-profit organizations, and numerous pension and mutual funds." *Id.* at 2-3.

To facilitate the efforts of state and local governments and private asset fund managers to divest from companies involved in four specific business sectors in Sudan, Congress enacted the SADA in 2007. *Id.* at 1, 4. Congress sought to allow such divestment "to reduce the financial or reputational risk associated with investments in a country subject to international sanctions." *Id.*

at 1-2; *see also id.* at 6-7. With respect to private divestment, § 4 of the SADA, entitled "Safe Harbor for Changes of Investment Policies by Asset Managers," amended § 13 of the ICA by adding a new subsection (c). Pub. L. No. 110-174, § 4(a), 121 Stat 2519-20 (codified as amended at 15 U.S.C. § 80a-13(c)). Subsection (c) expressly barred any kind of civil, criminal, or administrative action against an investment company to challenge the company's divestment from the securities of companies conducting the affected business operations in Sudan. *Id.* It stated:

(c) Limitation on actions

(1) In general

> *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 employee, officer, director, or investment adviser thereof*, based solely upon the investment company divesting from, or avoiding investing in, securities issued by persons that the investment company determines, using credible information that is available to the public, conduct or have direct investments in business operations in Sudan described in

> section 3(d) of the Sudan Accountability and Divestment Act of 2007.
>
> (2) Applicability
>
> (A) Actions for breaches of fiduciary duties
>
> Paragraph (1) does not prevent a person from bringing an action based on a breach of a fiduciary duty owed to that person with respect to a divestment or non-investment decision, other than as described in paragraph (1).
>
> (B) Disclosures
>
> Paragraph (1) shall not apply to a registered investment company, or any employee, officer, director, or investment adviser thereof, unless the investment company makes disclosures in accordance with regulations prescribed by the Commission.
>
> (3) Person defined
>
> For purposes of this subsection the term “person” includes the Federal Government and any State or political subdivision of a State.

*Id.* (emphasis added). The report from the Senate Committee on Banking, Housing, and

Urban Affairs explained that the purpose of § 13(c) was to "provide[ ] a 'safe harbor' for those divestment decisions made in accordance with the [SADA]." S. Rep. No. 110-213, at 7.

In July 2010, months after this appeal was argued and more than two years after the investments that led to the filing of the complaint, Congress enacted the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 ("Iran Act"), Pub. L. No. 111-195, 124 Stat. 1312 (2010). As relevant to this appeal, the Iran Act amended ICA § 13(c)(1) to add a safe harbor for investment companies divesting from certain investments in Iran, and rewrote § 13(c)(2)(A) to say:

> Nothing in [§ 13(c)(1)] shall be construed to create, imply, diminish, change, or affect in any way whether or not a private right of action exists under [§ 13(a)] or any other provision of [the ICA].

*Id.* §§ 203(a), 205(b)(1), 124 Stat. at 1343, 1345. Congress specified that the amendment to § 13(c)(2)(A) "shall apply as if included in the [SADA]." *Id.* § 205(b)(2), 124 Stat. at 1345. The Conference Report for the Iran Act stated that this amendment was "designed to clarify that Congress did not intend, in the [SADA], to imply the creation of a new private right of action under the [ICA]." H.R. Rep. No. 111-512, at 67 (2010).

## BACKGROUND OF THIS LITIGATION

This litigation has nothing to do with divestment from the securities of companies doing business in Sudan. Rather, it involves 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 § 13(a) of the ICA.

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 seeks 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.

The Fund's stated investment objective is "to attempt to provide a high level of current income consistent with preservation of capital by seeking to track the investment results of [the Lehman Index] through the use of an indexing strategy." The Fund disclosed in its registration statement that this investment policy was "fundamental, which means that it may be changed only by vote of a majority of [the] Fund's shareholders." The Fund's concentration policy says that the Fund may not invest twenty-five percent or more of the Fund's total assets in any one industry or group of industries, unless necessary to track the Lehman Index.

Plaintiff-Appellee Northstar Financial Advisors, Inc. ("Northstar") is a registered investment advisory and financial planning firm that manages discretionary and non-discretionary 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 district court against Schwab Investments and Charles Schwab (collectively, "Schwab") for violations of ICA § 13(a). Northstar seeks to represent a class of investors who owned shares of the Fund from August 31, 2007, to the present.

Northstar's primary claim is that Schwab violated § 13(a) when it allegedly deviated from the Fund's fundamental investment policies. *Northstar*, 609 F. Supp. 2d at 940. Northstar alleges 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. *Id.* Northstar's complaint also includes state law claims for breach of fiduciary duty, breach of contract, and breach of the covenant of good faith and fair dealing that are not at issue in this appeal. *Id.* at 948-50.

Schwab moved to dismiss the action for lack of standing on the part of Northstar, asserting that Northstar could not raise claims on behalf of its clients, who are the actual shareholders of the Fund. *Id.* at 941. The district court granted this motion, but permitted Northstar to amend its complaint to reflect its standing as the assignee of a client-shareholder, and standing is not an issue in this appeal. *Id.* at 942.

Schwab also moved to dismiss for failure to state a claim under ICA § 13(a), asserting there is no private right of action to enforce that section's terms. *Id.* at 943. The district court denied this motion, holding that there is an implied private right of action under § 13(a). *Id.* at 944. The court first rejected Northstar's assertion that this court had already conclusively decided the issue in *Lapidus v. Hecht*, 232 F.3d 679 (9th Cir. 2000), correctly observing that this court merely assumed without deciding in that case that an implied private right of action exists under § 13(a). *Northstar*, 609 F. Supp. 2d at 943 (citing

*Lapidus*, 232 F.3d at 681 n.4). The court then declined to adopt the Second Circuit's reasoning in *Olmsted* to deny a private right to enforce § 13(a), because *Olmsted* "predated" the 2007 amendment of § 13 by the SADA. *Id.* at 944. Relying on the language of subsection (c) added to § 13 by the SADA, the court held that Congress recognized a private right to enforce § 13(a) when it enacted § 13(c). *Id.* at 944-45. The court reasoned that there was no basis for Congress to bar actions based on Sudanese divestments if the statute did not authorize other private causes of action. The district court said:

> The Court finds it significant that Section 13(c) expressly limited the types of actions that a "person" could file under Section 13. If 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. [Schwab] argue[s] Section 13(c) cannot be read as referring to Section 13(a) or any other specific statutory provision, and they note that there is nothing in the legislative history suggesting that Section 13(c) was meant to imply a private right of action under Section 13(a). However, if 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. The fact that Congress only limited certain types of actions suggests that Congress intended that there be a private right of action under Section 13(a).

*Id.* at 944-45.

Recognizing, however, that the issue of whether there is an implied private right of action to enforce § 13(a) is not free from doubt, the district court certified its decision for interlocutory appeal, which this court accepted. *See* 28 U.S.C. § 1292(b).

**ANALYSIS**

We must now decide whether there is a private right to enforce § 13(a) of the ICA. This is a question of statutory construction that we review de novo. *In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1229 (9th Cir. 2008). "[T]he fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person." *Touche Ross & Co. v. Reding-ton*, 442 U.S. 560, 568 (1979) (quoting *Cannon v. Univ. of*

*Chicago*, 441 U.S. 677, 688 (1979)) (internal quotation marks omitted). Instead, the statute must either explicitly create a private right of action or implicitly contain one. *In re Digimarc*, 549 F.3d at 1230. Both parties in this appeal agree that § 13(a) does not expressly create a private right of action.

Accordingly, if there is any private right to enforce § 13(a), it must be implied from the statute's language, structure, context, and legislative history. *Id.*; *Opera Plaza Residential Parcel Homeowners Ass'n v. Hoang*, 376 F.3d 831, 836 (9th Cir. 2004). As the party seeking to establish a private right to enforce § 13(a), the burden rests with Northstar to demonstrate that such a private right of action exists. *Opera Plaza*, 376 F.3d at 835. For the reasons explained below, Northstar has not met this burden.

**I. Language and Structure of the Act**

Our analysis of whether § 13(a) contains an implied private right of action begins with the language and structure of the statute itself. *Alexander v. Sandoval*, 532 U.S. 275, 288 (2001); *In re Digimarc*, 549 F.3d at 1231. This is because congressional intent to create a private right of action is the "key inquiry" in determining whether an implied private right to enforce the statute exists. *Opera Plaza,* 376 F.3d at 835; *see also Orkin v. Taylor*, 487 F.3d 734, 739 (9th Cir. 2007). In analyzing the language of § 13(a), we look for the presence of any "rights-creating language" that might imply Congress intended to confer upon shareholders the right to sue an investment company for violating the statute's requirements. *See Sandoval*, 532 U.S. at 288-89; *In re Digimarc*, 549 F.3d at 1231-32. We then look to the structure of the ICA itself. We have observed that "analogous provisions [of the statute] expressly providing for private causes of action can imply congressional intent not to create an implied cause of action." *Opera Plaza*, 376 F.3d at 836 (citing *Touche Ross*, 442 U.S. at 571-74). We also look to see whether Congress designated a method of enforcement other than through private lawsuits, because "[t]he express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others." *Sandoval*, 532 U.S. at 290.

**[1]** We turn first to whether the statute contains any language that would imply Congress intended to allow private enforcement of the statute's requirements, what in *Sandoval* is termed "rights-creating language." *Id.* at 288. Section 13(a) contains none. Instead, § 13(a) is focused on limiting the types of actions an investment company can take without first obtaining shareholder approval. "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.' " *Id.* at 289 (quoting *California v. Sierra Club*, 451 U.S. 287, 294 (1981)). This is because there is "far less reason to infer a private remedy in favor of individual persons if Congress, instead of drafting [the statute] with an unmistakable focus on the benefitted class," writes it "simply as a ban on" or "as a prohibition against" undesirable conduct by a regulated entity. *Cannon*, 441 U.S. at 690-92.

**[2]** Here, as in the district court, Northstar contends that in *Lapidus* we already construed the statute as creating a private right. The district court correctly said we did not. *Northstar*, 609 F. Supp. 2d at 943. As the district court explained, we found it unnecessary in *Lapidus* to reach the question of whether § 13(a) creates an implied private right of action. *Id.* This was because the district court in *Lapidus* had dismissed the plaintiffs' § 13(a) claims for lack of subject matter jurisdiction and not for failure to state a claim. *Lapidus*, 232 F.3d at 681. We said in a footnote in *Lapidus* that the existence of a private right to enforce § 13(a) could be "assumed without being decided" to resolve the jurisdictional question before us, because "the question whether a cause of action exists is not a question of jurisdiction." *Id.* at 681 n.4 (quoting *Burks v. Lasker*, 441 U.S. 471, 476 n.5 (1979)) (internal quotation marks and citation omitted). We resolved the jurisdictional question in the plaintiffs' favor, and remanded to the district court for consideration in the first instance of the defendants' other asserted grounds for dismissal. *Id.* at 684. On remand, the district court dismissed the plaintiffs' claims for failure to state a claim without addressing whether § 13(a) creates an implied private right of action. *Lapidus v. Hecht*, 2002 WL 1034042 (N.D. Cal. May 17, 2002). The language of the statute does not imply a private remedy, and we have never held that it did.

**[3]** We next turn to the structure of the ICA to determine whether it suggests any congressional intent to allow private enforcement. Our Circuit has not done this analysis, but the Second Circuit, twice in the past decade, has analyzed the ICA's statutory scheme for evidence of congressional intent to create a private right of action to enforce other sections of the Act, and has concluded that no such evidence exists. *See Bellikoff*, 481 F.3d at 116-17 (holding there is no private right of action to enforce ICA §§ 34(b), 36(a), and 48(a)); *Olmsted*, 283 F.3d at 432-33 (holding there is no private right of action to enforce ICA §§ 26(f) and 27(i)). In both *Bellikoff* and *Olmsted*, the Second Circuit focused on the fact that § 42 of the ICA, 15 U.S.C. 80a-41, authorizes SEC enforcement of the ICA, and that Congress actually created an express private right of action against investment advisors for breach of certain fiduciary duties in § 36(b). This led the Second

Circuit to conclude that Congress did not intend to imply a private right to enforce other sections of the ICA. *See Bellikoff*, 481 F.3d at 116-17; *Olmsted*, 283 F.3d at 433.

**[4]** We now agree with the Second Circuit that the structure of the ICA does not indicate that Congress intended to create an implied private right to enforce the individual provisions of the Act. In §§ 6 and 42 of the ICA, Congress expressly authorized the SEC to enforce all of the provisions of the Act by granting the Commission 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, consistent with the statutory purpose and the public interest. 15 U.S.C. §§ 80a-6(c), 80a-41. This thorough delegation of authority to the SEC to enforce the ICA strongly suggests Congress intended to preclude other methods of enforcement. *Sandoval*, 532 U.S. at 290. The Supreme Court has also cautioned that "where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it." *Transamerica*, 444 U.S. at 19. Because the statutory scheme of the ICA provides for thorough SEC enforcement of the Act's provisions, including § 13(a), "it is highly improbable that Congress absentmindedly forgot to mention an intended private action." *Id.* at 20 (internal quotation marks and citation omitted).

**[5]** Moreover, 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 when it wished to do so. In § 30(f) of the original 1940 Act (now codified at 15 U.S.C. § 80a-29(h)), Congress expressly authorized private suits for damages against insiders of closed-end investment companies who make short-swing profits. *Transamerica*, 444 U.S. at 20 & n.10. Congress created a second express private right of action in 1970 when it added § 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. 15 U.S.C. § 80a-35(b); *Bellikoff*, 481 F.3d at 116; *Olmsted*, 283 F.3d at 433. 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 § 13(a), indicates that Congress did not, by its silence, intend a private right of action to enforce § 13(a). *See In re Digimarc*, 549 F.3d at 1232-33.

Despite this strong evidence from the language of § 13(a) and the ICA's statutory scheme that Congress did not intend to create a private right of action to enforce § 13(a), Northstar argues that such a right can be implied from §§ 1, 33, and 44 of the Act. We disagree, as none of these sections demonstrate that Congress intended private enforcement of each of the provisions of the ICA.

Section 1, the congressional findings and declaration of policy, contains general language indicating that one of the purposes of the Act is to protect investors. 15 U.S.C. § 80a-1. That is a key function of the SEC. This general language does not demonstrate that Congress intended the ICA to be enforced by any entity other than the SEC. *See Sandoval*, 532 U.S. at 290; *Transamerica*, 444 U.S. at 24 ("[T]he mere fact that [a] statute was designed to protect [one class of individuals] does not require the implication of a private cause of action for damages on their behalf."); *Touche Ross*, 442 U.S. at 578 ("[G]eneralized references to the 'remedial purposes' of [an act] will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' " (quoting *SEC v. Sloan*, 436 U.S. 103, 116 (1978))).

Section 33 does nothing more than require investment companies and their affiliates to file certain litigation documents with the SEC whenever an investment company or one of its affiliates is a party to a suit against an officer, director, investment advisor, trustee, or depositor of the investment company. 15 U.S.C. § 80a-32. This filing requirement does not imply that Congress anticipated private suits against investment companies for violations of the ICA; the requirement applies to "any action or claim" and is not solely directed to suits for violations of the ICA. *Id.*

Section 44 is the ICA's jurisdictional provision; it grants concurrent federal and state jurisdiction over "all suits in equity and actions at law" brought to enforce the provisions of the entire ICA. 15 U.S.C. § 80a-43. It does not create a private right of action to enforce § 13(a). The entity entitled to sue for violations must be identified in the substantive provision of the act. *See Touche Ross*, 442 U.S. at 577 ("The source of plaintiffs' rights must be found, if at all, in the substantive provisions of the [act] which they seek to enforce, not in the jurisdictional provision.").

## II. Legislative History of Amendments to the Act

Northstar goes on to argue that even if the Act's language does not imply a private right to sue, the statute's legislative history, specifically the amendments to §§ 8 and 13 enacted in 1970 and 2007, demonstrates that Congress intended there to be an implied private right of action to enforce § 13(a). We must disagree, because nothing in the language or context of those amendments demonstrates a clear congressional intent to allow private lawsuits to enforce the statute's provisions.

## A. The 1970 Amendments

**[6]** Congress amended §§ 8 and 13 in 1970 to make it clear that an investment company's registration statement must recite all policies that can be changed only by shareholder vote and that deviation from any policy so designated violates § 13(a). Northstar contends that when Congress amended these two sections, it meant to affirm its original intent to create a private right of action under § 13(a). No such meaning or intent is apparent. The amendments deal with the need for shareholder votes to change investment policy. The language and legislative history reflect that purpose and that purpose only.

**[7]** The report of the House Committee on Interstate and Foreign Commerce states that the purpose of the amendments was "to make clear that deviation from an investment policy which is changeable only by shareholder vote constitutes a violation of section 13," regardless of whether the investment company's registration statement explicitly identifies the policy as "fundamental." H.R. Rep. No. 91-1382, at 19. By clarifying when a change of policy violates § 13(a), Congress did not thereby indicate an intent to recognize a private remedy for such a violation.

Northstar further contends that the 1970 amendments affirmed a contemporary federal court interpretation of § 13(a) as privately enforceable. Northstar tries to invoke the principle that when an implied cause of action is part of the "contemporary legal context" in which Congress amends a statute, and a significant amendment of the statute leaves intact the provisions the courts relied on for implying a cause of action, Congress intends the cause of action to remain. In this situation, the lack of change "is itself evidence that Congress affirmatively intended to preserve that remedy." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982). It is only evidence, however. The Supreme Court has cautioned that "dispositive weight" should not be given to the expectations Congress has with respect to the contemporary legal context. *Sandoval*, 532 U.S. at 287-88.

Here, we can give the expectations no weight, because there was no "contemporary legal context" in 1970, when Congress amended §§ 8 and 13 recognizing a private right of action under § 13(a). Northstar cites to only two cases — both from federal district courts — to support its theory that there was such a context: *Green v. Brown*, 276 F. Supp. 753 (S.D.N.Y. 1967), and *Leighton v. The One William Street Fund, Inc.*, 1965 U.S. Dist. LEXIS 9430 (S.D.N.Y. July 2, 1965).

Even assuming two district court, and hence non-precedential, cases could provide a legal context, neither *Green* nor *Leighton* actually held that there was an implied private right to enforce § 13(a). In *Green*, a stockholder of an investment company brought a derivative action against the company and its directors, alleging the defendants violated § 13(a) of the ICA by concentrating the company's investments in a manner contrary to the investment policy contained in the company's registration statement. *See* 276 F. Supp. at 754. The district court granted the defendants' motion for summary judgment, holding that the defendants had not violated § 13(a) because the company's registration statement did not characterize the investment policy at issue as a "fundamental policy," even though the registration statement said the policy could not be changed without shareholder approval. *Id.* at 755-56. The question of whether a private right of action to enforce § 13(a) even existed was not raised by any of the parties and was not addressed in the district court's decision. The House Report and other portions of the legislative history relating to the 1970 amendments to §§ 8 and 13 indicate that Congress was, of course, aware of *Green*, because it wanted to clarify the confusion *Green* had created about the need for shareholder votes. *See* H.R. Rep. No. 91-1382, at 19. There is no indication Congress thought the case stood for anything else. The amendments made it clear that any unapproved deviation from policies the registration statement says require a shareholder vote violate § 13(a).

The earlier district court case, *Leighton,* also involved whether shareholder approval was needed. In *Leighton*, a stockholder challenged an investment fund's decision to hire a certain investment advisor as its broker and to pay that advisor brokerage commissions. 1965 U.S. Dist. LEXIS 9430, at *6-8. The stockholder argued that decision, made without shareholder approval, amounted to a change in fundamental policy in violation of § 13(a) of the ICA. *Id.* at *6-7. The district court rejected this claim, entering summary judgment on behalf of the fund and its advisor because the fund's registration statement was silent on the matter of brokerage commissions. *Id.* at *7-8. The non-published opinion does not discuss the existence of a private right to enforce § 13(a). It held there had been no violation of § 13(a). Even if Congress had been aware of the *Leighton* decision when it amended §§ 8 and 13 in 1970, it could not have believed the amendments affirmed any recognition in *Leighton* of a private right to enforce § 13(a).

**B. The 2007 Amendments**

**[8]** Northstar's stronger argument, the one the district court accepted, is that Congress recognized a preexisting private right of action to enforce § 13(a) when it enacted the SADA in 2007 and added § 13(c) to the ICA. Section 13(c) is a broad prohibition of remedies for a narrow purpose. It prohibits the availability of any remedy or cause of action pertaining to an investment company's divestment from, or failure to invest in, securities of entities, but only of those that do business in the oil, power production, mineral extraction, or military equipment sectors of Sudan. *See* 15 U.S.C. § 80a-13(c)(1)(A). It is a broad prohibition because it bars all civil, criminal, and administrative actions, including state as well as federal claims, and it begins with the sweeping phrase "[n]otwithstanding any other provision of Federal or State law." *Id.* It has narrow application because it applies to Sudanese divestments.

Section 13(c) thus is a bar to actions any person or government agency might file to challenge divestment from Sudanese investments. The district court found it significant that § 13(c) referred to actions that a "person" could file, and that it included actions under § 13. *Northstar*, 609 F. Supp. 2d at 944. The court reasoned 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." *Id.* Thus, the argument concludes, Congress's use of the word "person" in § 13(c) must mean that private persons, and not just the SEC, are otherwise authorized to bring an action for a violation of § 13(a).

This argument would have some validity if the Sudanese bar in § 13(c) applied only to causes of action to enforce the other provisions of § 13, including § 13(a). But the bar is not so limited. The § 13(c) bar extends to any civil, criminal, or administrative action brought under any state or federal law. Thus, Congress included the term "person" to describe the entities restricted from bringing the types of actions barred by § 13(c), because a wide range of "persons" are potential plaintiffs when all possible civil, criminal, and administrative actions under both state and federal law are considered. Congress meant to bar all such potential plaintiffs from remedies for divestment. It did not limit the Sudanese bar to plaintiffs under § 13(a). Thus, we conclude Congress did not use the word "person" as recognition of a private right of action to enforce § 13(a).

The legislative history of the SADA supports our interpretation of the language of § 13(c) as barring actions beyond those for violations of the provisions of § 13. According to the report of the Senate Committee on Banking, Housing, and Urban Affairs, a primary purpose of the SADA was to permit public and private asset managers to adopt Sudanese divestment measures without fear of legal reprisals. S. Rep. No. 110-213, at 1-2. To this end, § 4 of the SADA added § 13(c) to the ICA to "allow[ ] private asset managers, if they so choose, to divest from the securities of companies conducting business operations in the power production, mineral extraction, oil, and military equipment sectors of Sudan," and to "provide[ ] a 'safe harbor' for those divestment decisions made in accordance with the [SADA]." *Id.* at 6-7. Congress could not have intended to restrict § 13(c)'s application solely to causes of action arising from divestments that might otherwise violate § 13(a).

Northstar nevertheless points to the heading of § 4 of the SADA as indicating that Congress intended ICA § 13(c) to apply only to causes of action arising from violations of ICA § 13(a). Section 4 of the SADA is entitled "Safe Harbor for Changes of Investment Policies by Asset Managers." Pub. L. No. 110-174, § 4, 121 Stat. at 2519. The somewhat attenuated argument is that the reference to "investment policies by asset managers" mirrors the language in ICA § 13(a)(3), which prohibits investment companies from deviating from certain types of "investment policies" without shareholder approval. Thus, Northstar concludes that § 4 of the SADA implies that ICA § 13(c), which was added to the ICA by SADA § 4, was explicitly intended to modify ICA § 13(a).

**[11]** Assuming, arguendo, that such a meaning can be attached to the words in the title, the Supreme Court has cautioned that "the title of a statute and the heading of a section cannot limit the plain meaning of the text. For interpretative purposes, they are of use only when they shed light on some ambiguous word or phrase." *Bhd. of R.R. Trainmen v. Baltimore & O.R. Co.*, 331 U.S. 519, 528-29 (1947). Here, the text of ICA § 13(c) unambiguously applies to all actions that can be brought under "any other provision of Federal or State law." 15 U.S.C. § 80a-13(c)(1). It is not limited to actions for violations of ICA § 13(a). Thus, Congress's use of the term "investment policy" both in the heading of SADA § 4 and in the text of ICA § 13(a)(3) cannot be parsed to reflect any intent to restrict § 13(c)'s application to violations of § 13(a), much less to constitute a recognition of private causes of action to challenge them.

Congress's recent amendment of ICA § 13(c)(2)(A) is in accord with our understanding of the relationship between § 13(a) and (c). This amendment expressly stated that § 13(c)(1) does not create or affect the existence of a private right of action under § 13(a). It provides: "Nothing in [§ 13(c)(1)] shall be construed to create, imply, diminish, change, or affect in any way whether or not a private right of action exists under [§ 13(a)] or any other provision of [the ICA]." 15 U.S.C. § 80a-13(c)(2)(A). The amendment undermines the district court's holding.

Northstar finally contends that when Congress enacted the SADA in 2007, it affirmed a private cause of action courts had recognized in the preceding 40 years. It contends there was by 2007 "unanimous case law confirming the private right of action."

Northstar cites fifteen cases, yet in fourteen the issue was either not squarely raised or not squarely decided. As we have already seen, this court in *Lapidus* only assumed, without deciding, that a private right of action exists under § 13(a). *See* 232 F.3d at 681 n.4. In both *Karpus v. Hyperion Capital Mgmt., Inc.*, 1996 WL 668860, at *2 (S.D.N.Y. Nov. 18, 1996), and *Potomac Capital Markets Corp. v. Prudential-Bache Corporate Dividend Fund, Inc.*, 726 F. Supp. 87, 93 n.5 (S.D.N.Y. 1989), the district court acknowledged that the issue of whether there is a private right of action to enforce § 13(a) had not been raised. Eleven of the other cases cited by Northstar contain no discussion of the issue whatsoever. *See, e.g., Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 731-32 (2d Cir. 1998); *Rodney v. KPMG Peat Marwick*, 143 F.3d 1140, 1143 (8th Cir. 1998) (does not include any claim brought under § 13(a)); *Green*, 398 F.2d at 1008; *Phillips v. Morgan Stanley Dean Witter High Income*

*Advantage Trust III*, 2002 WL 31119441, at *3-4 (S.D.N.Y. Sept. 25, 2002); *Lapidus*, 2002 WL 1034042, at *2-9; *Sheppard v. TCW/DW Term Trust 2000*, 938 F. Supp. 171, 180 n.7 (S.D.N.Y. 1996); *Krounder v. Am. Heritage Fund, Inc.*, 899 F. Supp. 142, 148-49 (S.D.N.Y. 1995); *Omni Fin. Corp. v. Cohen*, 1994 WL 97125, at *6-7 (S.D.N.Y. Mar. 22, 1994); *Monheit v. Carter*, 376 F. Supp. 334, 339 (S.D.N.Y. 1974); *Green*, 276 F. Supp. at 755-56; *Leighton*, 1965 U.S. Dist. LEXIS 9430, at *6-8.

The one case in which the court did have such an issue squarely before it and did hold that § 13(a) implies a private right of action was *Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 916 F. Supp. 1343 (D.N.J. 1996). The district court's decision in Blatt, however, did not rely on the text or history of § 13(a) itself. The court instead relied on § 7(d), 15 U.S.C. § 80a-7(d), and the court's conclusion that a private right of action existed to enforce that provision of the ICA. *Blatt*, 916 F. Supp. at 1348-50, 1357. Section 7(d) prohibits foreign investment companies from issuing securities in interstate commerce without first registering with the SEC. Section 7(d) is unrelated to § 13(a). We believe the approach taken in *Blatt* is in some tension with the Supreme Court's later teaching in *Sandoval,* requiring closer analysis of the particular provision in question to determine the existence of an implied private right of action. *See Sandoval*, 532 U.S. at 286-91.

Indeed, following the Supreme Court's decision in *Sandoval*, the modern trend has been for federal courts to deny the existence of implied private rights of action under the ICA, with many courts applying the analytical framework employed by the Second Circuit in *Olmsted* and *Bellikoff*. *See, e.g., W. Inv. LLC v. DWS Global Commodities Stock Fund, Inc.*, ___ F. Supp. 2d ___, 2010 WL 1404208, *3-4 (S.D.N.Y. Apr. 5, 2010) (holding there is no implied private right of action under § 13(a)(3) of the ICA and rejecting district court's reasoning in this case in favor of the rationale relied on in *Olmsted* and *Bellikoff*); *In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579, 591-93 (S.D.N.Y. 2006) (holding there is no private right of action to enforce §§ 34(b) and 48(a) of the ICA and citing other post-*Olmsted* cases in the same district that reached the same conclusion); *In re Franklin Mut. Funds Fee Litig.*, 388 F. Supp. 2d 451, 464-67 (D.N.J. 2005) (holding there is no implied private right of action to enforce §§ 34(b) and 36(a) of the ICA and citing other post-*Sandoval* and post-*Olmsted* cases reaching the same conclusion); *Mutchka v. Harris*, 373 F. Supp. 2d 1021, 1025-27 (C.D. Cal. 2005) (holding there is no implied private right of action to enforce § 36(a) of the ICA); *White v. Heartland High-Yield Mun. Bond Fund*, 237 F. Supp. 2d

982, 986-88 (E.D. Wis. 2002) (holding that §§ 22 and 34(b) of the ICA do not create implied private rights of action).

In reversing the district court in this case, we follow the conclusion reached by the Second Circuit in *Olmsted* and *Bellikoff*, and supported by the weight of contemporary authority, that there is no implied private right of enforcement.

## CONCLUSION

Neither the language of § 13(a), the structure of the ICA, nor the statute's legislative history, including the addition of § 13(c), the Sudanese amendment, in 2007, reflect any congressional intent to create, or recognize a previously established, private right of action to enforce § 13(a). The job of enforcement remains exclusively with the SEC.

**[12]** The order of the district court is reversed and the matter remanded with instructions to grant Schwab's motion to dismiss Northstar's federal claims.

**REVERSED** and **REMANDED.**

## APPENDIX D – OPINION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA DECIDED FEBRUARY 19, 2009

## IN THE UNITED STATES DISTRICT COURT

## FOR THE NORTHERN DISTRICT OF CALIFORNIA

| | |
|---|---|
| NORTHSTAR FINANCIAL ADVISORS INC,<br><br>Plaintiff,<br><br>v.<br><br>SCHWAB INVESTMENTS; *et al*,<br><br>Defendants.<br>_____________________/ | No. C 08-4119 SI<br><br>**ORDER GRANTING IN PART AND DENYING IN PART MOTION TO DISMISS WITH LEAVE TO AMEND** |

On January 23, 2009, the Court heard argument on defendants' motion to dismiss the complaint. For the reasons stated below, the Court GRANTS IN PART AND DENIES IN PART the motion and GRANTS leave to amend.

*Appendix D*

## BACKGROUND

Plaintiff Northstar Financial Advisors, Inc. ("Northstar") filed this class action lawsuit on behalf of all persons who owned shares of the Schwab Total Bond Market Fund (the "Fund") at any time from August 31, 2007 to the present. Complaint ¶ 1. Northstar is a registered investment advisory and financial planning firm serving both institutional and individual clients. *Id.* ¶ 9. Northstar manages both discretionary and nondiscretionary accounts on behalf of investors in its role as an investment advisor. *Id.* Northstar trades through Charles Schwab's Institutional Advisor Platform, and purchased shares in the Fund for its clients. *Id.* ¶¶ 11-12.

Northstar alleges that defendants violated the Section 13(a) of the Investment Company Act of 1940 ("ICA") by deviating from the Fund's investment objective to track the Lehman Brothers U.S. Aggregate Bond Index (the "Index") in two ways. First, Northstar alleges that the Fund deviated from this objective by investing in high risk non-U.S. agency collateralized mortgage obligations ("CMOs") that were not part of the Lehman Index and were substantially more risky than the U.S. agency securities and other instruments that comprised the Index. *Id.* ¶ 3. Second, Northstar alleges that the Fund deviated from its investment objectives which prohibited any concentration of investments greater than 25%

in any industry by investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed securities and CMOs. *Id.* ¶ 4.

Northstar alleges that defendants' deviation from the Fund's investment objective exposed the Fund and its shareholders to tens of millions of dollars in losses due to a sustained decline in the value of non-agency mortgage-backed securities. The Funds' deviation from its stated investment objective caused it to incur a negative total return of 1.09% for the period September 4, 2007 through August 27, 2008, compared to a positive return of 5.92% for the Index over that period. *Id.* ¶ 5.

## LEGAL STANDARD

Under Federal Rule of Civil Procedure 12(b)(6), a district court must dismiss a complaint if it fails to state a claim upon which relief can be granted. The question presented by a motion to dismiss is not whether the plaintiff will prevail in the action, but whether the plaintiff is entitled to offer evidence in support of the claim. *See Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds by Davis v. Scherer*, 468 U.S. 183 (1984).

In answering this question, the Court must assume that the plaintiff's allegations are true and must draw all reasonable inferences in the plaintiff's favor. *See Usher v. City of Los Angeles*, 828 F.2d 556, 561 (9th Cir. 1987). However, the Court is not required to accept as true "allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences." *St. Clare v. Gilead Scis., Inc. (In re Gilead Scis. Sec. Litig.)*, 536 F.3d 1049, 1055 (9th Cir. 2008). To survive a Rule 12(b)(6) motion to dismiss, the plaintiff must allege "enough facts to state a claim to relief that is plausible on its face." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955, 1974 (2007). While courts do not require "heightened fact pleading of specifics," a plaintiff must provide "more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do." *Id.* at 1965. Plaintiff must allege facts sufficient to "raise a right to relief above the speculative level." *Id.*

If the Court dismisses the complaint, it must then decide whether to grant leave to amend. The Ninth Circuit has "repeatedly held that a district court should grant leave to amend even if no request to amend the pleading was made, unless it determines that the pleading could not possibly be cured by the allegation of other facts." *Lopez v. Smith*, 203 F.3d 1122, 1130 (9th Cir. 2000) (citations and internal quotation marks omitted).

## DISCUSSION

### I. Standing

Defendants contend that because Northstar is an investment advisor that only purchased shares for its clients and not for itself, Northstar lacks constitutional standing. Defendants note that although the complaint is brought as a class action on behalf of "persons who owned shares of the Schwab Total Bond Market Fund," Northstar never actually owned shares of the Fund and instead only purchased them on behalf of its clients. Defendants rely on *W.R. Huff Asset Management Company, LLC v. Deloitte & Touche LLP*, 549 F.3d 100 (2d Cir. 2008), in which an investment advisor alleged it had constitutional standing to sue on behalf of its clients as both their investment advisor and "attorney-in-fact." *Id.* at 104. The investment advisor did not allege in the complaint that it suffered any direct injury; instead, all of the alleged injury was suffered by the advisor's clients. *Id.* at 107. The Second Circuit held that the investment advisor lacked standing as an investment advisor because "the investment advisor-client relationship is not the type of close relationship courts have recognized as creating a 'prudential exception' to the third-party standing rules" and because the advisor "failed to demonstrate that, absent a recognition of its standing claim, there is a 'hindrance' to the [clients'] ability to protect their own interests."

*Id.* at 110. The court rejected the advisor's standing based on its status as "attorney-in-fact" because the advisor's "power-of-attorney permits it to serve as an agent of its clients and to conduct litigation on behalf of its clients as their attorney-in-fact, but . . . is not purported to be a valid assignment and does not confer a legal title to the claims Huff brings." *Id.* at 109.

In response, Northstar argues that *Huff* is distinguishable because Northstar has suffered a direct financial injury because "Northstar operates under a fee-based structure based on the total value of assets under management." Complaint ¶ 12. Northstar also has obtained an assignment of claims from one of its clients, Finkel Decl. Ex. F, and states that it can amend the complaint to allege the assignment.

The Court finds that the complaint does not allege that Northstar has suffered an injury in fact sufficient to confer constitutional standing, but that Northstar could amend the complaint to cure these deficiencies. As defendants note, the complaint alleges that it is brought on behalf of a class of persons who owned shares of the Fund. Complaint ¶ 1. Under *Huff*, which this Court finds persuasive, Northstar cannot bring claims on behalf of its clients simply by virtue of its status as an investment advisor.[1] The

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[1] In support of its contention that it has constitutional standing, plaintiff cites several cases in

assignment of claims from one of Northstar's clients would, however, cure this deficiency. The Court also finds that Northstar would likely have standing to sue in its own right due to the direct financial injury it alleges that it suffered due to the decline in total value of assets under management. *See Miller v. Dyadic Int'l Inc.*, No. 07-80948-CIV, 2008 WL 2465286, at *10 (S.D. Fla. Apr. 18, 2000) (investment advisor had alleged injury sufficient to meet the constitutional injury in fact requirement because it was compensated based on the performance and value of the portfolios under its management). However, the complaint as currently framed is not brought on behalf of Northstar directly, but on behalf of Northstar's clients, and thus does not seek to redress Northstar's injuries.

Accordingly, the Court GRANTS defendants' motion to dismiss for lack of standing, and GRANTS plaintiff leave to amend to cure the deficiencies noted above. Because the Court finds

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which investment advisors have been appointed "lead plaintiff" under the Private Securities Litigation Reform Act. *See Employers-Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Anchor Capital Advisors*, 498 F.3d 920 (9th Cir. 2007); *Takeda v. Turbodyne Techn. Inc.*, 67 F. Supp. 2d 1129 (C.D. Cal. 1999). However, as the Huff court noted, the PSLRA's lead plaintiff standards "are separate and apart from the elements of constitutional standing . . . and cannot be used to avoid constitutional requirements." 549 F.3d at 106.

that Northstar can cure the standing deficiency by amendment, the Court addresses defendants' other arguments in favor of dismissal.

## II. Private right of action under Section 13(a)

Section 13(a) of the ICA provides:

> (a) No registered investment company shall, unless authorized by a 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.

15 U.S.C. § 80a-13(a). Section 13(a) does not explicitly provide for a private remedy, and the burden is on plaintiff to show that a private right of action may be implied under this section. *See Opera Plaza Residential Parcel Homeowners Ass'n v. Hoang*, 376 F.3d 831, 835 (9th Cir. 2004). Contrary to plaintiff's assertions, this question is unresolved in the Ninth Circuit; *Lapidus v. Hecht*, 232 F.3d 679 (9th Cir. 2000), did not hold that there is an implied private right of action under Section 13(a), and indeed found it unnecessary to reach that question: "The United States Supreme Court has expressly declined to address whether there exists an implied private right of action under the ICA. However, because the question whether a cause of action exists is not a question of jurisdiction, it may be assumed without being decided." *Id*. at 681 n.4 (internal citations and quotations omitted). The district court in *Lapidus* had dismissed the plaintiffs' Section 13(a) claim for lack of subject matter jurisdiction. On appeal, the Ninth Circuit reversed the jurisdictional holding and remanded for further proceedings. On remand, the district court dismissed the plaintiffs' claims for failure to state a claim. *Lapidus v. Hecht*, C 98-3130 MMC, 2002 WL 1034042 (N.D. Cal. May 17, 2002). The district

court did not address whether there was an implied private right of action under Section 13(a).[2]

"In determining whether a federal statute creates a private right of action, congressional intent is the cornerstone of the analysis." *Orkin v. Taylor*, 487 F.3d 734, 738 (9th Cir. 2007). Courts consider four factors to decide whether a statute creates a private right of action: "(1) whether the plaintiff is a member of a class that the statute especially intended to benefit, (2) whether the legislature explicitly or implicitly intended to create a private cause of action, (3) whether the general purpose of the statutory scheme would be served by creation of a private right of action, and (4) whether the cause of action is traditionally relegated to state law such that implication of a federal remedy would be inappropriate." *Id.* at 738-39 (citing *Cort v. Ash*, 422 U.S. 66, 78 (1975)).

Defendants urge this Court to adopt the reasoning of *Olmsted v. Pruco Life Insurance Company*, 283 F.3d 429 (2d Cir. 2002), in which the Second Circuit held that there is no private right of action under Sections 26(f) and 27(i) of the ICA.[3] In Olmsted, the court found that the

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[2] Plaintiff's counsel here was also counsel of record in Lapidus.

[3] Sections 26(f) and 27(i) state that it shall be unlawful for any account funding variable insurance contracts, or the sponsoring insurance company of such

Act's text created a "strong presumption" that Congress did not intend to create private rights of action under Sections 26(f) and 27(i). The court noted that the language of these sections only describes actions by insurance companies that are prohibited, and do not mention investors such as the plaintiffs. *Id.* at 433 ("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." *Alexander v. Sandoval*, 532 U.S. 275, 289 (2001)). The court also found it significant that Section 42 of the ICA explicitly provides for enforcement of all provisions of the Act, including Sections 26(f) and 27(i), by the SEC, and that Congress had explicitly provided for a private right of action in Section 36(f) for investors in regulated investment companies alleging that investment advisors breached certain fiduciary duties. *Id.* at 433.

The Court directed the parties to submit supplemental briefing on the relevance, if any, of the amendment of Section 13 to add subsection (c), "Limitation on actions," to the question of whether there is a private right of action under Section 13(a). In December 2007, Congress amended Section 13 to restrict the rights of "persons" to bring actions with respect to

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an account, to sell any such contract unless the fees and charges deducted under the contract are reasonable. See 15 U.S.C. § 80a-26(f); 15 U.S.C. § 80a-27(i)(2).

investments in Sudan. Section 13(c) 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 employee, officer, director, or investment adviser thereof, based solely upon the investment company divesting from, or avoiding investing in, securities issued by persons that the investment company determines, using credible information that is available to the public, conduct or have direct investments in business operations in Sudan described in section 3(d) of the Sudan Accountability and Divestment Act of 2007. 15 U.S.C. § 80a-13(c)(1). Section 13(c)(2) further states that "Paragraph (1) does not prevent a person from bringing an action based on breach of fiduciary duty owed to that person with respect to a divestment or a non-investment decision, other than as described in paragraph (1)." *Id.* § 80a-13(c)(2).

Plaintiff contends that Section 13(c) demonstrates that actions under Section 13(a) are privately enforceable because 13(c) uses the word "person," which is defined in the ICA as a "natural person or company." 15 U.S.C. § 80a-2(a)(28); *see also* 15 U.S.C. § 80a-13(c)(3) (expanding definition of "person" to include "the Federal Government and any State or political subdivision of a State"). Plaintiff argues that by using the word "person" in a provision of the statute that explicitly addresses limitations on Section 13 actions, Congress recognized that the statute authorizes private actions. Defendants argue that Section 13(c), which was part of the Sudan Accountability and Divestment Act of 2007, does not create an express right of action under Section 13(a), and nothing in the text or legislative history of 13(c) evidences any Congressional intent to recognize an implied private right of action for Section 13(a).

The Court concludes that there is an implied private right of action under Section 13(a). The Court notes that many of the cases addressing claims under Section 13(a) do not address whether there is a private right of action, but rather solely discuss whether the plaintiff had stated a claim under that Section. *See, e.g., Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 731-32 (2d Cir. 1998); *Lapidus*, 2002 WL 1034042, at *2-9. Plaintiff cites two cases which expressly hold that there is a private right of action under Section 13(a). *Potomac Capital Markets Corp. v. Prudential-Bache Corp. Dividend Fund, Inc.*, 726 F. Supp. 87 (S.D.N.Y. 1989); *Blatt v. Merrill Lynch*, 916 F. Supp. 1343 (D.N.J. 1996). However, both of these cases arose within the Second Circuit, and the *Olmsted* court cited both of these cases as belonging to an "ancien regime" of "[p]ast decisions reflecting judicial willingness to 'make effective [statutory] purpose in the context of implied rights of action.'" *Olmsted*, 283 F.3d at 434 & n.4 (*quoting Sandova*l, 532 U.S. at 289).

However, to the extent that *Olmsted* suggests that there is no private right of action under Section 13(a), the Court notes that *Olmsted* predated the amendment of Section 13. The Court finds it significant that Section 13(c) expressly limited the types of actions that a "person" could file under Section 13. If 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. Defendants argue Section 13(c) cannot be read as referring to Section 13(a) or any other specific statutory provision, and they note that there is nothing in the legislative history suggesting that Section 13(c) was meant to imply a private right of action under Section 13(a). However, if 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. The fact that Congress only limited certain types of actions suggests that Congress intended that there be a private right of action under Section 13(a). *Cf. Marley v. United States*, 548 F.3d 1286, 1292 (9th Cir. 2008) ("[I]f

Congress had intended to grant exceptions to the [Federal Tort Claims Act] limitations period, it would have done so expressly"); *Boise Cascade Corp. v. U.S. E.P.A.*, 942 F.2d 1427, 1432 (9th Cir. 1991) ("Under accepted canons of statutory interpretation, we must interpret statutes as a whole, giving effect to each word and making every effort not to interpret a provision in a manner that renders other provisions of the same statute inconsistent, meaningless or superfluous.").

## III. Stating a claim under Section 13(a)

Section 80a-8 of the ICA requires an investment company[4] to list in its registration statement all investment policies which are changeable only if authorized by shareholder vote, as well as all policies that the registrant deems matters of fundamental policy. *See* 15 U.S.C. § 80a-8(b)(2) and (3). Section 80a-13 prohibits an investment company from deviating from any of these policies "unless authorized by the vote of a majority of its outstanding voting securities." 15 U.S.C. § 80a-13(a). Northstar alleges that defendants violated Section 13(a) by

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[4] Plaintiff concedes that Schwab Investments is the only proper defendant named in the Section 13(a) claim because by its express terms Section 13(a) applies only to a "registered investment company." Accordingly, the other three defendants are dismissed from the Section 13(a) claim.

failing to track the Lehman Index Fund and by deviating from its concentration policy.

### A. Failing to track Lehman Index Fund

The Fund's prospectus states that the Fund "seeks high current income by tracking the performance of the Lehman Brothers U.S. Aggregate Bond Index." Docket No. 60, Ex. A at 13 (July 13, 2007 Prospectus). According to the prospectus, the Lehman Brothers U.S. Aggregate Bond Index includes "investment-grade government, corporate, mortgage-, commercial mortgage- and asset-backed bonds that are denominated in U.S. dollars and have maturities longer than one year. Investment-grade securities are rated in the four highest rating categories (AAA to BBB-). Bonds are represented in the index in proportion to their market value." Prospectus at 13. The 1997 Proxy Statement stated that the Fund's strategy was "designed to maintain high credit-quality standards" because the Index was comprised primarily of "U.S. Treasuries, government agency securities and government agency mortgage-backed securities." *Id.* ¶ 54. The 1997 Proxy Statement also stated that "U.S. Treasury and agency securities have the lowest credit risk compared to other types of fixed income securities," and "[t]he mortgage backed securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac, and maintained in the Lehman Index, had the highest quality among mortgage-backed securities." *Id.* ¶¶ 41, 61.

Plaintiff alleges that the Fund deviated from its fundamental investment objective by making sizable investments[5] in non-agency CMOs that were significantly more risky than the agency-issued mortgage backed securities that were part of the Index. Plaintiff emphasizes the statement in the 1997 Proxy Statement that the Fund's investment's would be "managed" "through statistical sampling and other procedures" "to closely approximate [the] Index's characteristics," Complaint ¶ 37, and the SAI's statement that the Fund would use an "indexing strategy" to "track the investment results" of the Index. Docket No. 56 (Sept. 1, 2006 SAI at *2). Plaintiff acknowledges that the prospectus and SAI both state that the Fund is not required to invest any percentage of its assets in the securities represented in the Index, and also that these documents disclose that the Fund may invest in CMOs. However, plaintiff alleges that by investing heavily in non-agency CMOs that are not part of the Index, the Fund violated its investment objective of using an "indexing strategy" to "track" and "closely approximate" the Index.

Defendants contend that failing to achieve an investment objective is not the same thing as

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[5] The complaint alleges that according to schedules appended to the February 28, 2008 Semi-Annual Report, the Fund had invested 27.3% of its assets as of February 28, 2007 in non-agency CMOs. Complaint ¶ 72.

violating it, and that the actual language of the Fund's investment objective makes this clear because the fund said only that it "seeks" and will "attempt" to track the index. Defendants note that the Fund tracked the returns of the Lehman Index for nearly ten years, and only fell short of the Index for several months. Defendants emphasize the prospectus' warning that "[t]here can be no guarantee that [the fund] will produce the desired results." Prospectus at 17. Defendants also argue that the investment in non-agency CMOs was not inconsistent with the Fund's investment objective to track the Index because the Fund's stated investment objective does not say anything about CMOs. Instead, the investment objective says only that the Fund will employ an indexing strategy. Defendants emphasize that the prospectus informs investors that the Fund may invest in securities that are not part of the Index, including mortgage-backed securities and CMOs, Prospectus at 14, and that the SAI contains a four page discussion of mortgage-backed securities.

The Court concludes that Northstar's allegations are sufficient to state a claim that the Fund's significant investments in non-agency CMOs violated the Fund's investment objective. The prospectus and SAI informed investors that the Fund would "track" the performance of the Lehman Index, and that the "fund uses the index as a guide in structuring the fund's portfolio and selecting its investments." Prospectus at 14.

Defendants are correct that the simple fact that the Fund invested in CMOs that were not part of the Index does not, on its own, violate the Fund's investment objective. However, plaintiff alleges not only that the Fund invested in non-agency CMOs that were not part of the Index, and which were significantly more risky than the agency CMOs that were part of the Index, but also that the Fund's investment in non-agency CMOs was sizable. Complaint ¶ 72. Given the statements in the 1997 Proxy Statement, as well as the prospectus and SAI about the Fund's use of an "indexing strategy" to "track" the results of the Index, the Court finds that plaintiff has stated a claim under Section 13(a). Whether the Fund's investments in non-agency CMOs were, in fact, inconsistent with its investment objective of tracking the Index, is a factual matter that cannot be resolved on the pleadings.

**B. Concentration policy**

Northstar also alleges that defendants violated Section 13(a) by investing more than 25% of the Fund in mortgage-backed securities in violation of the Fund's concentration policy which limits the Fund's investments in any one industry to less than 25% of the Fund's assets. Neither the ICA nor any SEC regulation defines "industry." The SEC has published guidelines relating to registration statements for mutual funds, *Registration Form Used by Open-End Mgmt. Inv. Cos.; Guidelines*, SEC Release Nos.

33-6479, IC-13436 (August 12, 1983) (Finkel Decl. Ex. C). Guide 19, "Concentration of Investments in Particular Industries," states:

> In determining industry classifications . . . [a] registrant . . . may select its own industry classifications, but such classifications must be reasonable and should not be so broad that the primary economic characteristics of the companies in a single class are materially different. Registrants selecting their own industry classifications must be reasonable and should disclose them (a) in the prospectus in the case of policy to concentrate, or (b) in the Statement of Additional Information in the case of a policy not to concentrate.

*Id.* at *74. In 2006, the Fund changed its classification of non-agency mortgage-backed securities as constituting an "industry" to not constituting an "industry." The September 1, 2006 SAI states,

> **Concentration** means that substantial amounts of assets are invested in a particular industry or industries. Concentration increases investment exposure. For purposes of a fund's concentration policy, the fund will determine the industry classification of asset-backed securities based upon the investment adviser's evaluation of the risks associated with an investment in the

underlying assets. For example, asset-backed securities whose underlying assets share similar economic characteristics because, for example, they are funded (or supported) primarily from a single or similar source or revenue stream will be classified in the same industry sector. In contrast, asset-backed securities whose underlying assets represent a diverse mix of industries, business sectors and/or revenue streams will be classified into distinct industries based on their underlying credit and liquidity structures. . . . *The funds have determined that mortgage-backed securities issued by private lenders do not have risk characteristics that are correlated to any industry and, therefore, the funds have determined that mortgage-backed securities issued by private lenders are not part of any industry for purposes of the funds' concentration policies*. This means that a fund may invest more than 25% of its total assets in privately-issued mortgage-backed securities, which may cause the fund to be more sensitive to adverse economic, business or political developments that affect privately-issued mortgage-backed securities. Such developments may include changes in interest rates, state or federal legislation affecting residential mortgages

> and their issuers, and changes in the overall economy.

SAI at *8 (emphasis added). Plaintiff alleges that by reclassifying mortgage-backed securities as not constituting an "industry," the Fund was able to increase its investments in mortgage-backed securities without seeking shareholder approval to modify the concentration policy.

Defendants agree that the Fund must obtain shareholder approval before changing its "concentration policy," but argue that changing an industry classification is not a change to a "concentration policy." Instead, defendants contend that the Fund's "concentration policy" is contained in the SAI, under "Investment Limitations," which states that the Fund may "[n]ot concentrate investments in a particular industry or group of industries, or within one state (except to the extent that the index which each fund seeks to track is also so concentrated) as concentration is defined under the Investment Company Act of 1940 or the rules or regulations thereunder, as such statute, rules or regulations may be amended from time to time." SAI at *39. Defendants argue that the Fund's reclassification of mortgage-backed securities was "reasonable" as required by SEC Rule 19. Defendants have submitted evidence that another large investment company manager, the Pacific Investment Management Company (PIMCO), likewise does not classify mortgage-backed securities as an "industry," and they assert that “no standard classification system of which we are aware defines ‘mortgage-backed securities’ as an industry.” Motion at 11.

The Court finds that whether the Fund violated the concentration policy which prohibits investing more than 25% of the Fund’s assets in a single industry turns on whether mortgage-backed securities are properly considered an “industry,” a factual matter which the parties presently dispute. If, as plaintiff alleges, mortgage-backed securities constitute an “industry,” the Fund bypassed – and effectively violated – the concentration policy by improperly reclassifying mortgage-backed securities. If, as defendants contend, the Fund’s reclassification of mortgage-backed securities was reasonable, there was no violation of the concentration policy. This cannot be resolved at the current stage of the pleadings.[6]

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[6] The cases cited by defendants are factually distinguishable because the alleged violations did not implicate the concentration policies of the Funds. *See Phillips v. Morgan Stanley Dean Witter High Income Advantage*, No. 01 CIV.8139 DC, 2002 WL 31119441 (S.D.N.Y. Sept. 25, 2002) (where policy only prohibited concentration of investments in specified “industries,” no violation of implied policy not to concentrate investments in “group of industries”); *In re Alliance North American Government Income Trust, Inc. Securities Litigation*, No. 95 Civ 0330 (LMM), 1996 WL 551732 (S.D.N.Y. Sept. 27, 1996) (no violation of policy that Fund “may not invest 25% or more of its total assets in securities of companies

### C. Statute of limitations

Defendants also contend that plaintiff's Section 13(a) claim is untimely because the Fund disclosed its investments in non-agency CMOs and its concentration percentage in mortgage-backed securities in SEC filings more than one year before Northstar filed this action. The limitations period begins once a plaintiff has either actual or inquiry notice of the facts giving rise to the claim. *See Betz v. Trainer Wortham & Co.*, 519 F.3d 863, 874 (9th Cir. 2008). Plaintiff argues that it was not on notice of its potential claims until late 2007 at the earliest. The Court finds that when plaintiff was on notice of its claims, and whether a reasonable investor would have discovered the facts underlying plaintiff's claims in 2005 or 2006 as defendants contend, raise factual issues that are inappropriate for resolution at this stage of the litigation. Defendants may renew the statute of limitations argument on a fuller factual record.

## IV. State law claims

Plaintiff has also alleged three state law claims: breach of fiduciary duty, breach of contract, and breach of the covenant of good faith

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engaged principally in any one industry" when Fund "approved a change in the Fund's investment policies that increases to 25% from 10%, the percentage of the Fund's total assets that may be invested in debt securities issued by governmental entities of Argentina").

and fair dealing. The gravamen of each claim is that defendants breached their duties and contracts (the 1997 Proxy statement and subsequent prospectuses) by deviating from the Fund's stated investment objectives and fundamental policies. To the extent that defendants move to dismiss the state law claims on the same grounds discussed above – namely, that the Fund did not deviate from its stated investment objectives and fundamental policies – the Court rejects those arguments.

### A. Breach of fiduciary duty

Defendants also contend that plaintiff's breach of fiduciary duty claim fails because pursuant to the "internal affairs" doctrine, that claim is governed by the law of the Trust's incorporation, Massachusetts, and Massachusetts law does not recognize such a claim by a shareholder against a corporation. Plaintiff asserts that the breach of fiduciary duty claim is governed by California law, and that under California law, plaintiff may state a claim against each of the defendants for breach of fiduciary duty.

The Court has reviewed the cases cited by the parties, and finds that they are unhelpful to the questions presented. For example, none of defendants' "internal affairs" cases squarely addresses whether a breach of fiduciary duty claim such as the one alleged here – that investments were made in violation of stated investment objectives -- is subject to the narrowly applied doctrine. The internal affairs doctrine applies to matters "peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders" and include "steps taken in the course of the original incorporation, . . . the adoption of by-laws, the issuance of corporate shares, the holding of directors' and 'shareholders' meetings, . . . the declaration and payment of dividends and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its own stock." *Friese v. Superior Court*, 134 Cal. App. 4th 693, 706-07 (2005). In the absence of on point authority,[7] it is not clear that plaintiff's breach of

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[7] For example, in *Davis & Cox v. Summa Corporation*, 751 F.2d 1507, 1527 (9th Cir. 1985), a case involving the Howard Hughes estate, the Ninth Circuit held that corporate indemnification is subject to the internal affairs doctrine, and noted that it was "like the fiduciary obligations of corporate directors." In *Friese* the court held that an insider trading claim against a foreign corporation based on the California Corporations Code was not barred by the internal affairs doctrine. In rejecting the defendants' argument to the contrary, the court stated, "Rather [defendants] suggest section 25502.5 gives rise to no more than a derivative breach of fiduciary duty claim which they argue is, for that reason, subject to the internal affairs doctrine. For a number of reasons we do not accept defendants' characterization of section

fiduciary duty claim is subject to the "internal affairs" doctrine.

However, even if defendants are correct that plaintiff's breach of fiduciary duty claim is governed by Massachusetts law, they concede that such a claim could be alleged against the "proper defendants."[8] Plaintiff, for its part, asserts without citation to any authority that Schwab Investments is a proper defendant under California law. Plaintiff also requests leave to amend the breach of fiduciary duty claim. Accordingly, the Court finds it prudent to GRANT plaintiff leave to amend the breach of fiduciary duty claim. Plaintiff is directed to carefully examine whether each of the defendants named in this claim can in fact be named in such a claim, and under which state's law such a claim is properly brought. After review of the amended complaint, defendants may renew their motion to dismiss this claim.

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25502.5 as merely a device for enforcing directors' and officers' fiduciary duties to shareholders." *See* 134 Cal. App. 4th at 710. Neither of these cases squarely holds that all breach of fiduciary duty claims are governed by the internal affairs doctrine.

8 Defendants state that "[w]e do not argue that no person or entity owes a fiduciary duty to the fund's investors. But Northstar has not sued any of the proper defendants – it has instead sued the fund itself." Reply at 12.

### B. Breach of contract/breach of covenant of good faith and fair dealing

Plaintiff alleges that "defendants violated the terms of the contract with the Fund's shareholders as set forth in the 1997 Proxy and subsequent prospectuses . . . by directing the purchases or allowing the Fund to direct the purchases, of the above referenced securities, that deviated from the composition of the Lehman Brothers U.S. Aggregate Bond Index." Complaint ¶ 93. Defendants contend that, as a matter of law, the proxy statement and prospectuses cannot constitute contracts. However, the cases cited by defendants do not broadly hold that these documents can never constitute contracts. *See McKesson HBOC, Inc. v. N.Y. State Common Retirement Fund*, 339 F.3d 1087, 1092 (9th Cir. 2003) (prospectus seeking shareholder ratification of merger did not constitute contract between shareholders and corporation, separate merger agreement between corporations was contract at issue); *Cohen v. Stratosphere Corp.*, 115 F.3d 695, 701 (9th Cir. 1997) (prospectus stating "there can be no assurance that if the Minimum Offering is achieved that any additional Units will be sold," and reserving the "right to withdraw or cancel such offer and to reject any subscription in whole or in part" lacked mutual assent and intent to be bound that are required for the formation of a contract to sell securities).

Defendants also contend that the complaint does not specifically allege how the Proxy and the prospectuses are contracts, such as what language within each document shows that an investor can accept the terms and create a final and binding agreement. Defendants also note that while plaintiff purports to bring this claim against all defendants, plaintiff only specifically mentions Schwab Investments. Because plaintiff will be amending the complaint in various ways described supra, the Court finds it appropriate to GRANT plaintiff leave to amend the breach of contract claim to add more specific allegations regarding the language plaintiff relies on to allege the formation of a contract, as well as each defendants' involvement.

Finally, defendants contend that plaintiff's breach of covenant of good faith and fair dealing claim fails because plaintiff has not alleged the type of egregious and willful conduct required to support this claim. The Court finds that the complaint is sufficient as a pleading matter, and accordingly DENIES defendants' motion to dismiss this claim.

## CONCLUSION

For the foregoing reasons and for good cause shown, the Court hereby GRANTS in part and DENIES in part defendants' motion to dismiss. (Docket No. 33). Plaintiff shall file an amended complaint no later than **March 2, 2009**.

**IT IS SO ORDERED**.

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| Dated February 19, 2009 | SUSAN ILLSTON<br>United States District Judge |

## APPENDIX E – CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS

**U.S. CONST., art. III § 2, cl. 1: Jurisdiction of Courts**

The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority;--to all Cases affecting Ambassadors, other public Ministers and Consuls;--to all Cases of admiralty and maritime Jurisdiction;--to Controversies to which the United States shall be a Party;--to Controversies between two or more States;--between a State and Citizens of another State;--between Citizens of different States;--between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects.

**11 U.S.C. §§ 77p(b), 77p(f): Additional remedies; limitation on remedies**

(b) Class action limitations

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging--

(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

(2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

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(f) Definitions

For purposes of this section, the following definitions shall apply:

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(2) Covered class action--

(A) In general

The term "covered class action" means--

(i) any single lawsuit in which--

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which--

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

**11 U.S.C. §§ 77r(a)(1), 77r(a)(2), 77r(b)(2), 77r(c)(1): Exemption from State regulation of securities offerings**

(a) Scope of exemption

Except as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—

(1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that—

(A) is a covered security; or

(B) will be a covered security upon completion of the transaction;

(2) shall directly or indirectly prohibit, limit, or impose any conditions upon the use of--

(A) with respect to a covered security described in subsection (b) of this section, any offering document that is prepared by or on behalf of the issuer; or

(B) any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission or any national securities organization registered under section 78o-3 of this title, except that this subparagraph does not apply to the laws, rules, regulations, or orders, or other administrative actions of the State of incorporation of the issuer

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(b) Covered securities

For purposes of this section, the following are covered securities:

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(2) Exclusive Federal registration of investment companies

A security is a covered security if such security is a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940 [15 U.S.C.A. § 80a-1 et seq.].

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(c) Preservation of authority

(1) Fraud authority

Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions, in connection with securities or securities transactions

(A) with respect to—

(i) fraud or deceit; or

(ii) unlawful conduct by a broker, dealer, or funding portal; and

(B) in connection to a transaction described under section 77d(6) of this title, with respect to—

(i) fraud or deceit; or

(ii) unlawful conduct by a broker, dealer, funding portal, or issuer.

**11 U.S.C. § 77v(a): Jurisdiction of offenses and suits**

(a) Federal and State courts; venue; service of process; review; removal; costs

The district courts of the United States and the United States courts of any Territory shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, except as provided in section 77p of this title with respect to covered class actions, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. In any action or proceeding instituted by the Commission under this subchapter in a United States district court for any judicial district, a subpoena issued to compel the attendance of a witness or the production of documents or tangible things (or both) at a hearing or trial may be served at any place within the United States. Rule 45(c)(3)(A)(ii) of the Federal Rules of Civil Procedure shall not apply to a subpoena issued under the preceding sentence. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of Title 28. Except as provided in section 77p(c) of this title, no case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against it in the Supreme Court or such other courts.

**11 U.S.C. § 77z-2: Application of safe harbor for forward-looking statements**

(a) Applicability

This section shall apply only to a forward-looking statement made by—

(1) an issuer that, at the time that the statement is made, is subject to the reporting requirements of section 78m(a) or 78*o*(d) of this title;

(2) a person acting on behalf of such issuer;

(3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or

(4) an underwriter, with respect to information provided by such issuer or information derived from information provided by the issuer.

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(c) Safe harbor

(1) In general

Except as provided in subsection (b) of this section, in any private action arising under this subchapter that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) of this section shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that--

(A) the forward-looking statement is--

(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement--

(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or

(ii) if made by a business entity, was--

(I) made by or with the approval of an executive officer of that entity, and

(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.

**11 U.S.C. § 80a-8(b): Registration of investment companies**

(b) Registration statement; contents

*Appendix E*

Every registered investment company shall file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations, an original and such copies of a registration statement, in such form and containing such of the following information and documents as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

(1) a recital of the policy of the registrant in respect of each of the following types of activities, such recital consisting in each case of a statement whether the registrant reserves freedom of action to engage in activities of such type, and if such freedom of action is reserved, a statement briefly indicating, insofar as is practicable, the extent to which the registrant intends to engage therein: (A) the classification and subclassifications, as defined in sections 80a-4 and 80a-5 of this title, within which the registrant proposes to operate; (B) borrowing money; (C) the issuance of senior securities; (D) engaging in the business of underwriting securities issued by other persons; (E) concentrating investments in a particular industry or group of industries; (F) the purchase and sale of real estate and commodities, or either of them; (G) making loans to other persons; and (H) portfolio turn-over (including a statement showing the aggregate dollar amount of

purchases and sales of portfolio securities, other than Government securities, in each of the last three full fiscal years preceding the filing of such registration statement);

(2) a recital of all investment policies of the registrant, not enumerated in paragraph (1), which are changeable only if authorized by shareholder vote;

(3) a recital of all policies of the registrant, not enumerated in paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy;

(4) the name and address of each affiliated person of the registrant; the name and principal address of every company, other than the registrant, of which each such person is an officer, director, or partner; a brief statement of the business experience for the preceding five years of each officer and director of the registrant; and

(5) the information and documents which would be required to be filed in order to register under the Securities Act of 1933 [15 U.S.C.A. § 77a et seq.] and the Securities Exchange Act of 1934 [15 U.S.C.A. § 78a et seq.], all securities (other than short-term paper) which the registrant has outstanding or proposes to issue.

**11 U.S.C. § 8a-13(a): Changes in investment policy**

(a) 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.

*Appendix E*

**<u>17 C.F.R. § 230.485</u>: Effective date of post-effective amendments filed by certain registered investment companies**

(a) Automatic effectiveness.

(1) Except as otherwise provided in this section, a post-effective amendment to a registration statement filed by a registered open-end management investment company, unit investment trust or separate account as defined in section 2(a)(37) of the Investment Company Act of 1940 [15 U.S.C. 80a–2(a)(37) ] shall become effective on the sixtieth day after the filing thereof, or a later date designated by the registrant on the facing sheet of the amendment, which date shall be no later than eighty days after the date on which the amendment is filed.

(2) A post-effective amendment filed by a registered open-end management investment company for the purpose of adding a series shall become effective on the seventy-fifth day after the filing thereof or a later date designated by the registrant on the facing sheet of the amendment, which date shall be no later than ninety-five days after the date on which the amendment is filed.

(3) The Commission, having due regard to the public interest and the protection of investors,

may declare an amendment filed under this paragraph (a) effective on an earlier date.

(b) Immediate effectiveness. Except as otherwise provided in this section, a post-effective amendment to a registration statement filed by a registered open-end management investment company, unit investment trust or separate account as defined in section 2(a)(37) of the Investment Company Act of 1940 [15 U.S.C. 80a–2(a)(37) ] shall become effective on the date upon which it is filed with the Commission, or a later date designated by the registrant on the facing sheet of the amendment, which date shall be not later than thirty days after the date on which the amendment is filed, except that a post-effective amendment including a designation of a new effective date pursuant to paragraph (b)(1)(iii) of this section shall become effective on the new effective date designated therein, Provided, that the following conditions are met:

(1) It is filed for no purpose other than one or more of the following:

(i) Bringing the financial statements up to date under section 10(a)(3) of the Securities Act of 1933 [15 U.S.C. 77j(a)(3) ] or Rules 3–12 or 3–18 of Regulation S–X [17 CFR 210.3–12 and 210.3–18];

(ii) Complying with an undertaking to file an amendment containing financial statements, which may be unaudited, within four to six months after the effective date of the registrant's registration statement under the Securities Act of 1933 [15 U.S.C. 77a et seq.];

(iii) Designating a new effective date for a previously filed post-effective amendment pursuant to paragraph (a) of this section, which has not yet become effective, Provided, that the new effective date shall be no earlier than the effective date designated in the previously filed amendment under paragraph (a) of this section and no later than thirty days after that date;

(iv) Disclosing or updating the information required by Item 5(b) or 10(a)(2) of Form N–1A [17 CFR 239.15A and 274.11A];

(v) Making any non-material changes which the registrant deems appropriate;

(vi) In the case of a separate account registered as a unit investment trust, to make changes in the disclosure in the unit investment trust's registration statement to reflect changes to disclosure in the registration statement of the investment company in which the unit investment trust invests all of its assets; and

(vii) Any other purpose which the Commission shall approve.

(2) The registrant represents that the amendment is filed solely for one or more of the purposes specified in paragraph (b)(1) of this section and that no material event requiring disclosure in the prospectus, other than one listed in paragraph (b)(1) of this section or one for which the Commission has approved a filing under paragraph (b)(1)(vii) of this section, has occurred since the latest of the following three dates:

(i) The effective date of the registrant's registration statement;

(ii) The effective date of its most recent post-effective amendment to its registration statement which included a prospectus; or

(iii) The filing date of a post-effective amendment filed under paragraph (a) of this section which has not become effective.

(3) The amendment recites on its facing sheet that the registrant proposes that the amendment will become effective under paragraph (b) of this section.

(4) The representations of the registrant referred to in paragraph (b)(2) of this section shall be

made by certification on the signature page of the post-effective amendment that the amendment meets all the requirements for effectiveness under paragraph (b) of this section. If counsel prepared or reviewed the post-effective amendment filed under paragraph (b) of this section, counsel shall furnish to the Commission at the time the amendment is filed a written representation that the amendment does not contain disclosures that would render it ineligible to become effective under paragraph (b) of this section.

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(d) Subsequent amendments.

(1) Except as provided in paragraph (d)(2) of this section, a post-effective amendment that includes a prospectus shall not become effective under paragraph (a) of this section if a subsequent post-effective amendment relating to the prospectus is filed before such amendment becomes effective.

(2) A post-effective amendment that includes a prospectus shall become effective under paragraph (a) of this section notwithstanding the filing of a subsequent post-effective amendment relating to the prospectus, *Provided*, that the following conditions are met:

(i) the subsequent amendment is filed under paragraph (b) of this section; and

(ii) the subsequent amendment designates as its effective date either:

(A) the date on which the prior post-effective amendment was to become effective under paragraph (a) of this section; or

(B) a new effective date designated under paragraph (b)(1)(iii) of this section.

In this case the prior post-effective amendment filed under paragraph (a) of this section and any prior post-effective amendment filed under paragraph (b) of this section shall also become effective on the new effective date designated under paragraph (b)(1)(iii) of this section.

(3) Notwithstanding paragraphs (d)(1) and (d)(2) of this section, if another post-effective amendment relating to the same prospectus is filed under paragraph (a) of this section before the prior amendments filed pursuant to paragraphs (a) and (b) of this section have become effective, none of such prior amendments shall become effective under this section.

*Appendix E*

**17 C.F.R. § 230.497: Filing of investment company prospectuses—number of copies**

(a) Five copies of every form of prospectus sent or given to any person prior to the effective date of the registration statement that varies from the form or forms of prospectus included in the registration statement filed pursuant to § 230.402(a) shall be filed as part of the registration statement not later than the date that form of prospectus is first sent or given to any person, except that an investment company advertisement under § 230.482 shall be filed under this paragraph (a) (but not as part of the registration statement) unless filed under paragraph (i) of this section.

(b) Within 5 days after the effective date of a registration statement or the commencement of a public offering after the effective date of a registration statement, whichever occurs later, 10 copies of each form of prospectus used after the effective date in connection with such offering shall be filed with the Commission in the exact form in which it was used.

(c) For investment companies filing on Form N–1A (§ 239.15A and § 274.11A of this chapter), Form N–2 (§ 239.14 and § 274.11a–1of this chapter), Form N–3 (§ 239.17a and § 274.11b of this chapter), Form N–4 (§ 239.17b and § 274.11c of this chapter), or Form N–6 (§

239.17c and § 274.11d of this chapter), within five days after the effective date of a registration statement or the commencement of a public offering after the effective date of a registration statement, whichever occurs later, ten copies of each form of prospectus and form of Statement of Additional Information used after the effective date in connection with such offering shall be filed with the Commission in the exact form in which it was used. Investment companies filing on Form N–1A must, if applicable pursuant to General Instruction C.3.(g) of Form N–1A, include an Interactive Data File (§ 232.11 of this chapter).

(d) After the effective date of a registration statement no prospectus which purports to comply with section 10 of the Act and which varies from any form of prospectus filed pursuant to paragraph (b) or (c) of this rule shall be used until 10 copies thereof have been filed with, or mailed for filing to, the Commission.

(e) For investment companies filing on Form N–1A (§ 239.15A and § 274.11A of this chapter), Form N–2 (§ 239.14 and § 274.11a–1of this chapter), Form N–3 (§ 239.17a and § 274.11b of this chapter), Form N–4 (§ 239.17b and § 274.11c of this chapter), or Form N–6 (§ 239.17c and § 274.11d of this chapter), after the effective date of a registration statement, no prospectus that purports to comply with Section

10 of the Act (15 U.S.C. 77j) or Statement of Additional Information that varies from any form of prospectus or form of Statement of Additional Information filed pursuant to paragraph (c) of this section shall be used until five copies thereof have been filed with, or mailed for filing to the Commission. Investment companies filing on Form N–1A must, if applicable pursuant to General Instruction C.3.(g) of Form N–1A, include an Interactive Data File (§ 232.11 of this chapter).