Nos. 11-55859 & 11-55958

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

HOLLY HANSON, ET AL.,
Plaintiffs-Appellants in No. 11-55859,

v.

MORGAN STANLEY SMITH BARNEY LLC,
Defendant-Appellee.

MARCIA BLOEMENDAAL, ET AL.,
Plaintiffs-Appellants in No. 11-55958,

v.

MORGAN STANLEY SMITH BARNEY LLC,
Defendant-Appellee.

Appeal from the United States District Court
for the Central District of California
Case Nos. CV 10-1455, CV 10-6945, The Honorable Dale S. Fischer

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CORPORATE DISCLOSURE STATEMENT

Defendant Morgan Stanley Smith Barney LLC is a limited liability company whose sole member is Morgan Stanley Smith Barney Holdings LLC. Morgan Stanley Smith Barney Holdings LLC is a limited liability company owned, directly or indirectly, by Morgan Stanley and Citigroup Inc., each of which holds more than a 10% interest.

Respectfully submitted,

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INTRODUCTION[1]

This appeal is about whether a class of plaintiffs wielding state-law claims can blunt one of the most important and effective federal legislative and regulatory schemes established in recent years to police against insider trading.

In the wake of the stock market crash of 1987, Congress sounded an alarm over "a dramatic increase" of "serious episodes of abusive and illegal practices on Wall Street." H.R. Rep. 100-910, at 7, 10 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044, 6048.[2] The wave of "insider trading and other market abuses" "represent[ed] far more than the transgressions of a few individuals" and "demonstrated the potential for abuse in even the largest and most prestigious of Wall Street securities firms." *Id*. at 7, 14. As Congress understood, in any large securities firm, thousands of employees are privy to inside information and any one of them can potentially trade on that information undetected by regulatory authorities and to the grave detriment of the investing public. To "restore the

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[1] The *Hanson* Plaintiffs' Brief and Excerpts of Record are cited as "*Hanson* Br." and "HER," respectively. The *Bloemendaal* Plaintiffs' Brief and Excerpts of Record are cited as "*Bloemendaal* Br." and "BER," respectively. Although Morgan Stanley & Co. is a separate entity from the joint venture, Morgan Stanley Smith Barney LLC, for convenience, this brief will refer to the joint venture as "Morgan Stanley." Morgan Stanley's Supplemental Excerpts of Record are cited as "SER."

[2] The House Report, as well as pertinent statutes, regulatory provisions, and administrative materials are including in Morgan Stanley's accompanying Addendum.

confidence of the public in the fairness and integrity of our securities markets," Congress saw "a clear need for an institutional, rather than merely individual, response." *Id.* at 7, 14-15. As Congress put it, "firms whose lifeblood is the continued public trust in our securities markets must do more to share in the responsibility for policing those markets and should be subject to considerable penalties for a shirking of that responsibility." *Id.* at 15. This premise of firms "policing th[e] markets" was the animating principle of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).

Congress's approach was simple: Enlist securities firms, themselves, to act as the first line of defense against insider trading and other market abuses—and hold them accountable if their defenses fail. Congress purposely provided only limited guidance about *how* firms should perform their supervisory functions. As Congress appreciated, every firm is different and even a single firm might comprise divisions with vastly different operations and cultures. Accordingly, the statute dictated that firms, themselves, under the watchful eyes of federal regulators, must be free to choose the means that are most effective, "taking into consideration the nature of such broker's or dealer's business," which firms understand better than anyone else. 15 U.S.C. § 78o(g).

Defendant-Appellee Morgan Stanley and its predecessor entities adopted a supervisory approach that Congress, the SEC, and various other regulatory bodies

understood to be ubiquitous and singularly effective: The company's general policy during the time period relevant to this litigation was to require employees to maintain self-directed personal trading accounts in-house. Management considered requests for exceptions case by case, but the firm granted only limited exceptions because of the difficulties of reliably monitoring outside accounts.

Plaintiffs-Appellants in these consolidated cases are former Morgan Stanley employees who assert that the firm's employee trading policy violates California law. Specifically, they argue that California Labor Code § 450 categorically requires Morgan Stanley to allow any employee to use outside trading accounts with or without the firm's approval (at least if the firm charges employees to trade in-house, which any rational firm would). Caving to the potential for crushing liability that Plaintiffs hope to impose through their state-law claims, Morgan Stanley has retreated from the supervisory mechanism it (and just about every brokerage firm in the country) had deemed most effective in favor of a decidedly less comprehensive approach.

Applying settled principles of conflict preemption, the district court held Plaintiffs' state-law claims preempted. Every other district court to address the question has reached the same conclusion. This uniform view of the lower courts is correct for two reasons, corresponding with the two types of conflict preemption—impossibility preemption and obstacle preemption.

First, it is impossible to comply with both federal securities law and the provision of the California Labor Code Plaintiffs seek to enforce. An SEC-approved rule with the force of federal law prohibits employees from opening outside trading accounts unless they obtain their firm's "prior written consent." NYSE Rule 407(b). It is impossible for a meaningful "prior written consent" requirement to coexist with a purported state-law rule that prohibits firms from ever denying consent.

Second, and independently, Plaintiffs' state-law suits pose an obstacle to the accomplishment of significant federal objectives. Plaintiffs agree that their suits are preempted so long as Congress or the various federal regulatory agencies have a "significant" federal interest in empowering each firm to adopt the enforcement devices it deems most effective. *Bloemendaal* Br. at 24; *Hanson* Br. at 33. Here, the federal interest is much more than "significant." Congress wanted securities firms—under the direction of various federal regulators—to make the nuanced judgments as to which supervisory devices would be most effective in protecting the investing public. It surely did not delegate the choice of supervisory policy to state legislatures, much less to plaintiffs' lawyers representing disgruntled former employees and wielding vague and idiosyncratic state laws.

This Court should affirm the district court's sound conclusion that this lawsuit is preempted on either ground—or both.

ISSUES ON APPEAL

1. Federal law categorically prohibits Morgan Stanley's employees from opening personal brokerage accounts outside the firm without first obtaining their employer's written consent. Plaintiffs assert that California law requires Morgan Stanley to allow its employees to open such accounts without any such consent. Was the district court correct in holding that federal law conflicts with, and thus preempts, Plaintiffs' state-law claims, because it is impossible to comply simultaneously with both provisions?

2. Congress intended to allow brokerage firms to decide which supervisory mechanisms will most effectively protect the investing public from insider trading. Plaintiffs invoke state law in an effort to prevent Morgan Stanley from adopting an especially widespread and efficacious supervisory method—restrictions on outside accounts. Was the district court correct in holding that this lawsuit is preempted on the ground that it would stand as an obstacle to the achievement of significant federal objectives?

3. A federal statute authorizes self-regulatory organizations (SROs) to submit proposed rules to the SEC and authorizes the SEC to approve the rules only if it finds them consistent with the principles set forth in the statute. Since the New Deal, the Supreme Court has consistently held that even the broadest and most general directives are valid so long as they set forth an intelligible principle to

which the agency must conform. Should this Court reject Plaintiffs' new argument—raised for the first time on appeal—that the SRO rules amount to an excessive delegation of congressional power?

BACKGROUND

Federal Law Requires Broker-Dealers To Guard Against Insider Trading And Similar Misconduct By Their Employees

To advance "the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities," federal law "broadly prohibits deception, misrepresentation, and fraud 'in connection with the purchase or sale of any security.'" *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 78 (2006) (quoting 17 C.F.R. § 240.10b-5 (2005)); *see* Securities Exchange Act of 1934 (Exchange Act) § 10(b), 15 U.S.C. § 78j(b); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5(a), (c).

Chief among the evils that these federal antifraud provisions target is insider trading. It is illegal to buy or sell securities based on material, nonpublic information. *See, e.g.*, *United States v. O'Hagan*, 521 U.S. 642, 650-53 (1997). For broker-dealers and their employees, the prohibition on insider trading "takes a variety of forms and arises in many different contexts." Thomas Lee Hazen, *Law of Securities Regulation*, § 12.17[1], 2002 WL 690 (2011). In addition to their basic obligation not to trade on nonpublic, third-party information, broker-dealers and their employees also must steer clear of manipulative practices such as "front

running," which involves "trading ahead of customers' orders" in an effort to exploit anticipated price swings. *See id*. §§ 12.17[1], 14.3[6][C].

Congress, moreover, has placed affirmative obligations on securities firms to guard against insider trading and similar misconduct. As amended by ITSFEA, the Exchange Act requires broker-dealers to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this chapter, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." Exchange Act § 15(g), 15 U.S.C. § 78o(g). Congress's aim in enacting ITSFEA was to "increase the economic incentives for [broker-dealers] to supervise vigorously their employees." H.R. Rep. 100-910, at 17. Congress "expect[ed] that a firm's supervisory system would include, at a minimum, employment policies such as those requiring personnel to conduct their securities trading through in-house accounts or requiring that any trading in outside accounts be reported expeditiously to the employing firms." *Id*. at 22. Shortly after ITSFEA's enactment, the SEC conducted a survey of broker-dealer supervisory policies and determined that, in fact, "almost all firms require employees to maintain accounts with the firm." SEC Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material

Nonpublic Information, at 8 (1990), available at http://www.sec.gov/divisions/marketreg/brokerdealpolicies.pdf. [hereinafter "SEC Division of Market Regulation Report"].

ITSFEA authorizes draconian sanctions for failing to adequately prevent employee abuses. If the SEC determines that a broker-dealer's supervisory measures are inadequate, it can order the firm not just "to take steps to effect compliance" but to disgorge improper gains, with interest. Exchange Act § 21C(a), (e), 15 U.S.C. § 78u-3(a), (e). If the SEC concludes that a firm "knowingly or recklessly fail[s] to establish, maintain, or enforce any [required] policy or procedure," the firm also faces a civil penalty of up to "three times the amount of the profit gained or loss avoided as a result of" any related employee misconduct. Exchange Act § 21A(a)(3), (b)(1)(B), 15 U.S.C. § 78u-1(a)(3), (b)(1)(B).

In practice, much of the responsibility for enforcing ITSFEA's supervisory requirements falls in the first instance to self-regulatory organizations rather than the SEC. This is by design. The 1934 Act and its subsequent amendments "combine[] self-regulation by the securities exchanges with oversight and direct regulation by the SEC." *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097, 1108 (N.D. Cal. 2003). Two of the principal SROs are the Financial Industry Regulatory Authority (FINRA; formerly the National Association of

Securities Dealers (NASD)) and the New York Stock Exchange (NYSE).[3] These SROs have adopted detailed rules governing the day-to-day conduct of broker-dealers. With limited exceptions not relevant here, SRO rules take effect only after the SEC, following formal notice and comment, approves them, determining that they serve the objectives of the Exchange Act. *See* 15 U.S.C. § 78s(b); *see also* *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 233 (1987). Consequently, SRO rules have the force of federal law. *See infra* at 23.

Several SEC-approved SRO rules elaborate upon broker-dealers' obligations to prevent and detect abusive trading practices. Central to this case is NYSE Rule 407(b), which prohibits employees from opening trading accounts or conducting securities transactions at outside financial institutions "without the prior written consent" of their employer. NYSE Rule 407(b). Rule 407(b) operates in conjunction with NYSE Rule 342.21, which requires firms (a) to subject employees' personal trades "to review procedures that the … organization determines to be reasonably designed to identify trades that may violate the

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[3] In 2007, NASD and the NYSE's regulatory arm "consolidate[d] their member regulation operations into a single self-regulatory organization …. Pursuant to the Transaction, the member firm regulation and enforcement functions and employees from NYSE Regulation [were] transferred to NASD, and NASD … adopt[ed] a new corporate name"—"the Financial Industry Regulatory Authority" (FINRA). Securities & Exchange Commission, Release No. 34-56145 (July 26, 2007), *available at* http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.

provisions of the [Exchange Act]" or applicable SEC or SRO rules, and (b) to "[c]onduct promptly an internal investigation into" any questionable trades. Along similar lines, NASD and FINRA rules require broker-dealers to "establish and maintain" supervisory systems "reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable [SRO] Rules." NASD Rule 3010(a); *see also* FINRA Rule 3130(b) (requiring firms to certify that they have "in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules … and federal securities laws and regulations"). Thus, in addition to creating a default presumption that any personal trading accounts of firm employees should be kept in-house, SRO rules call for firms to adopt supervisory measures tailored to their individual circumstances. As one FINRA Rule puts it, "[i]t is critical that each FINRA member understand the importance of employing comprehensive and effective compliance policies and written procedures" and "establish, maintain, review, test and modify [them] in light of the nature of its businesses and the laws and rules that are applicable thereto." FINRA Rule 3130.03.

MSSB And Its Predecessors Maintained Employee Trading Policies To Comply With Their Federal-Law Obligations

Morgan Stanley Smith Barney is a retail brokerage firm formed in June 2009 as a joint venture between Morgan Stanley & Co.'s Global Wealth Management

Group and Citigroup's Smith Barney division. Morgan Stanley does not require, and the predecessor entities did not require, any employees to open brokerage accounts. BER 55, 64. For employees who choose to have such accounts, Morgan Stanley imposes (and the predecessor entities imposed) certain rules in furtherance of its obligations under federal law to prevent and detect insider trading and other abuses. *See, e.g.*, BER 64, 72, 176, 182.

None of the employee trading policies at issue in this litigation included a blanket prohibition on external brokerage accounts. But during the time period relevant to Plaintiffs' claims, the policies did indicate that, in the normal course, employees should keep certain brokerage accounts in-house. The 2006 version of Morgan Stanley's Employee Trading Policy, for example, advises that employees "generally must maintain all Employee Securities Accounts at the Firm, other than money market and open-end mutual fund accounts that cannot be used as brokerage accounts." BER 74; *see also* BER 78 (employees "may maintain money market and open-end mutual fund accounts away from the Firm as long as the accounts do not provide the ability to purchase or sell individual securities and other financial instruments"). According to the Policy, "[e]xceptions are rare and granted only by the express prior written approval of the Compliance Department and the manager designated by [the employee's] business unit or department to supervise employee trading activities." BER 74; *see also* BER 66 (explaining that

"[t]he Firm's determination of whether to grant an exception has been employee and investment specific"). Employees seeking "to open a securities account outside of the Firm" were required to submit an application and, if their application was approved, "to ensure that duplicate confirmations and statements are sent to the Firm." BER 74. The Policy also declared that the firm would monitor transactions in employee accounts "for a variety of factors such as frequency of trading, potential misuse of confidential information and conflicts." *Id*. The 2007, 2008, and 2009 versions of the Morgan Stanley's Policy contain similar language, as do the relevant versions of Smith Barney's Employee Trading Policy. *See* BER 85, 96, 108, 120 (Morgan Stanley); BER 185, 207, 237, 257, 273 (Smith Barney).

Such limitations on outside trading accounts are the norm in the financial-services industry, where employees often learn highly sensitive nonpublic information. *See* BER 64 ("[I]t is a recommended practice in the industry … for financial services firms that have their own broker-dealer operations to generally require (subject to limited exceptions) their employees to place their personal trades through the firm in order to prevent and detect potential securities violations and to comply with federal securities law and regulations."); *see also* BER 178.

The reason is simple:[4] A securities firm can more effectively prevent, detect, and correct misconduct when the employee uses an in-house account. As one of Morgan Stanley's compliance officers explained, without contradiction: "Being able to review trades placed in-house through Firm accounts … allows [Morgan Stanley's] Compliance department to perform its responsibilities in a way it cannot when an employee maintains an outside account …." BER 68-69; *see also* BER 177 (Citigroup compliance officer declares, without contradiction, that "[a]lthough Smith Barney did permit a limited number of outside accounts where an approved exception was granted, relative to in-house accounts the maintenance of outside accounts interfered with Smith Barney's compliance efforts in several key ways.").

First, Morgan Stanley "can detect and investigate potentially improper trades more effectively if an employee's account is maintained at the Firm because [the firm] can better analyze the employee's trading history and account information to determine if the trading activity is highly unusual relative to the size and composition of the employee's portfolio, and … can interview the financial advisor

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[4] The explanation that follows is drawn from the summary judgment record in *Bloemendaal,* and is therefore not part of the *Hanson* case, which was disposed of by motion to dismiss. But the reasons for a firm to favor this approach are self-evident, and, tellingly, the district court found the claims in *Bloemendaal* to be preempted without even mentioning this evidence in its analysis. The district court was therefore justified in dismissing the *Hanson* case on the same rationale. We present the information here for context.

involved in the account to understand the context in which it arose." BER 68. For in-house accounts, unlike outside accounts, Morgan Stanley has "the ability to evaluate the employee's in-house trading alongside the Firm's data on all client accounts using [Morgan Stanley's] proprietary software systems. Therefore, [the firm] can, first, detect violations that would not be apparent from the limited data provided on an outside account, which cannot be analyzed electronically against client trading even if the employee trading activity is provided in an electronic format." *Id.*

A good example is "the securities violation of 'front running,' wherein an employee … , after receipt of a large order from a client, places trades in the same security in his or her own account in anticipation of a later price change." *Id.* "For in-house accounts, [Morgan Stanley] ha[s] real-time access to both the client's and the employee's trading information, thus highlighting potential front-running violations that would not be apparent from analyzing only information received regarding employee trades executed outside the Firm." *Id.* Another example involves the misappropriation of client funds or shares. If an employee attempts to shift funds from a client's account to the employee's own personal in-house account, the firm "ha[s] real-time access to information showing movement of funds between accounts" and can thus immediately detect improper transfers. *Id.*

"[S]uch real-time fund transfer information is not accessible for outside accounts." *Id*.

Second, the firm "can more readily correct potential violations that occur in-house, for example, by reversing the trade." The firm "cannot do [that] in outside accounts." *Id.*

Third, Morgan Stanley "can more effectively investigate potential violations when the account is held internally, as [the firm has] ready access to the witnesses and other information needed to conduct the investigation." BER 68-69.

Plaintiffs File Actions Claiming That Morgan Stanley's Employee Trading Policies Violate California Law

The *Bloemendaal* and *Hanson* Plaintiffs are former employees of Morgan Stanley and/or its predecessor organizations who maintained in-house trading accounts during their employment. One of the two lead plaintiffs in the *Bloemendaal* case is David Notrica, whom the NYSE was formally investigating for insider trading when he left Morgan Stanley. *See* SER 9. In 2010, Plaintiffs filed two separate class actions in California state court on behalf of themselves and similarly situated persons. Morgan Stanley removed both suits to the United States District Court for the Central District of California. They were deemed "related cases" and assigned first to Judge S. James Otero and then Judge Manuel L. Real, both of whom recused themselves due to conflicts of interest. The cases

ultimately ended up before Judge Dale S. Fischer, who issued the rulings from which the Plaintiffs now appeal. *See* HER 1-13.

The relevant factual allegations and legal claims in the Plaintiffs' pleadings were virtually identical. In their Second Amended Complaint, filed December 15, 2010, the *Bloemendaal* Plaintiffs alleged, as relevant here, that Morgan Stanley "compelled and coerced them to purchase services of value" by requiring them to "maintain all securities accounts at the firm, subject to exceptions which are rarely granted." BER 1487. Likewise, the *Hanson* Plaintiffs' First Amended Complaint, filed February 14, 2011, alleged that Morgan Stanley "requires its employees and certain immediate family members, with very limited exceptions, to maintain their investment accounts at Morgan Stanley," thereby "causing them to pay higher fees that would pertain if they could patronize … another financial institution." HER 201-02. According to both complaints, Morgan Stanley's policies contravene California Labor Code § 450(a), which states that no employer "may compel or coerce any employee … to patronize his or her employer … in the purchase of any thing of value." Cal. Labor Code § 450(a). Plaintiffs contend this supposed § 450 violation "constitutes unfair competition as defined by [California] Business and Professions Code §§ 17200, *et seq*.," thus entitling Plaintiffs to recover "lost money or property," including the "personal brokerage account fees" Plaintiffs

paid to Morgan Stanley. BER 1487-88; HER 211. Plaintiffs also requested civil penalties, restitution, injunctive relief, and attorneys' fees. BER 1488; HER 212.

The District Court Concludes That Federal Law Preempts Plaintiffs' Compelled-Patronage Claims

Following some initial discovery, Morgan Stanley moved for summary judgment in *Bloemendaal* in February 2011. Morgan Stanley contended that the application of California Labor Code § 450 to employee trading accounts was preempted by the constellation of federal laws, regulations, and rules that require broker-dealers to monitor their employees' trading activities and maintain policies reasonably designed to prevent and detect abuses. Forcing the firm to allow all California employees to maintain outside accounts, Morgan Stanley explained, would frustrate the federal regulatory scheme and interfere with Morgan Stanley's ability to satisfy its federal-law obligations. A month later, in March 2011, Morgan Stanley filed a motion to dismiss in the *Hanson* case raising the same preemption argument.[5]

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[5] In its motions, Morgan Stanley also argued (1) that Plaintiffs' claims are barred by the Securities Litigation Uniform Standard Act of 1998 (SLUSA) and (2) that Plaintiffs' allegations did not amount to "compelled" or "coerced" patronage as a matter of California law. Before discovering the conflict that led to his recusal, Judge Otero dismissed a previous version of the *Hanson* Plaintiffs' Complaint pursuant to SLUSA, which precludes state-law class actions alleging untrue statements, material omissions, or manipulative or deceptive devices in connection with the purchase or sale of covered securities. *See* 15 U.S.C. § 77p(b)). Judge

The district court agreed with Morgan Stanley that Plaintiffs' § 450 claims are preempted. On May 23, 2011, the Court issued a thorough order granting Morgan Stanley's motion for summary judgment in *Bloemendaal*. The Court began by noting the black-letter rule that federal law displaces state enactments "when 'compliance with both federal and state regulations is a physical impossibility' or when state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" HER 6 (quoting *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963); *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)). The Court also observed that, under Ninth Circuit precedent, SEC-approved SRO rules stand on the same footing as federal statutes and regulations in terms of their preemptive effect. HER 9 (citing *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005)).

The district court then turned to the substance of federal securities law, in particular ITSFEA and its implementing regulations and rules. These federal enactments, the Court held, preempt Labor Code § 450 in the context of employee trading accounts for two related reasons: First, the application of § 450 would "undoubtedly frustrate[] the Congressional goals behind the Exchange Act and

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Fischer did not decide whether the *Hanson* Plaintiffs' amended pleadings cured the SLUSA defect; nor did she decide the SLUSA or compulsion issues in the *Bloemendaal* case. Because those issues remain unresolved, they are not before the Court in these appeals.

ITSFEA" by precluding broker-dealers from adopting and applying trading policies that account for "differences in business operations, structure, scope and nature." HER 10. "Congress expressly approved and expected" that firms, as part of their federally mandated supervisory systems, would have the ability to require employees to keep trading accounts in-house. *Id*.

Second, the Court concluded that Plaintiffs' claims were also preempted because it would be impossible for firms to comply simultaneously with both § 450 and NYSE Rule 407(b). Applying § 450 "would strip [broker-dealers] of [their] Congressionally authorized discretion to design a reasonable policy to prevent insider trading." HER 11. Broker-dealers would no longer be able to decide whether to "consent" to the opening of external accounts, as NYSE Rule 407(b) requires. Instead, they would be forced to allow such accounts as long as their employees provided notice.

Two days after issuing its decision in *Bloemendaal*, the district court issued a one-sentence order in *Hanson* granting Morgan Stanley's motion to dismiss "for the reasons given in the Court's Order Granting Defendant's Motion for Summary Judgment in *Bloemendaal v. Morgan Stanley Smith Barney LLC*." HER 1. On the heels of these decisions, two other district court judges—one in the Central District of California and one in the Northern District—dismissed similar § 450 claims based on a nearly identical preemption analysis. *See McDaniel v. Wells Fargo*

Invs., LLC, No. 10-4916 SC, 2011 WL 2976784 (N.D. Cal. July 22, 2011), *on appeal*, No. 11-17017; *Heilemann v. Bank of Am. Corp.*, No. CV 10-8623-GW(JGx), 2011 WL 244812 (C.D. Cal. June 6, 2011), *on appeal*, No. 11-55943.

These appeals are all being argued in the same sitting before the same panel. *See* Order in 11-55958, *Bloemendaal v. Morgan Stanley Smith Barney*, ECF. No. 11 (Nov. 21, 2011).

SUMMARY OF ARGUMENT

I. Preemption. Under our constitutional system, federal enactments displace conflicting state laws. Conflicts arise when it is impossible to comply fully with both state and federal law and also when the application of state law would frustrate significant federal purposes. The district court correctly held that both species of conflict are present here and that Plaintiffs' state-law claims are thus preempted.

A. *First*, it is impossible to comply with both Labor Code § 450 and NYSE Rule 407(b). As Plaintiffs seek to apply it, § 450 would give employees a right to do what Rule 407(b) expressly forbids—maintain outside trading accounts without obtaining "the prior written consent" of their employers. The whole point of Rule 407(b) is to require employers to make context-specific decisions about whether to allow employees to trade securities outside the firm. The application of Labor Code § 450 to employee trading accounts would preclude employers from making

those required judgments. In a closely analogous case that Plaintiffs simply cannot distinguish, this Court concluded that a California law requiring the disqualification of securities arbitrators had to give way to a federal rule that made disqualification discretionary in the same circumstances because simultaneous compliance with both provisions was impossible. Officials either had the discretion to disqualify arbitrators, or they didn't. So too here. Morgan Stanley either has the discretion to prevent employees from trading outside the firm, or it doesn't. It cannot be both.

Morgan Stanley's recent change of policy to allow California employees to maintain outside accounts does not show that simultaneous compliance with state and federal law is possible. Choosing the lesser of two evils under threat of litigation is hardly proof that Labor Code § 450 and NYSE Rule 407(b) are compatible. By making the decision it did, Morgan Stanley relinquished its right under federal law to make a context-specific assessment of the propriety of outside accounts.

B. *Second*, Plaintiffs' state-law claims are independently preempted because they stand as a formidable obstacle to achieving the objectives of the federal securities regulatory system. The federal regime depends on broker-dealers and regulators having the flexibility to adopt and enforce employee trading policies tailored to the unique circumstances of firms and their employees. Congress, the

SEC, and SROs have all made clear that restrictions on the use of outside trading accounts are one of the compliance tools that firms have at their disposal. By eliminating that option, the application of Labor Code § 450 to employee trading accounts necessarily hinders the capacity of firms to guard against employee misconduct.

C. Given the crystalline clarity of these conflicts, the presumption against preemption would not save Plaintiffs' claims even if it applied in this context. The presumption, however, is inapplicable because Morgan Stanley's employee trading policy is the product of a federal regulatory system and, moreover, because the regulation of the national securities markets is primarily an area of federal rather than state concern.

II. Delegation Doctrine. The *Bloemendaal* Plaintiffs' underdeveloped argument that the SRO rules applicable to Morgan Stanley and other financial services firms are invalid due to some sort of excessive delegation was not presented in the district court and is thus waived. In any event, Plaintiffs' radical position, which would sweep away the entire federal system of securities self-regulation, is completely meritless. It is belied not only by a long line of precedent limiting the application of the nondelegation doctrine, but also by the terms of the relevant federal laws.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY HELD THAT PLAINTIFFS' CALIFORNIA CLAIMS CONFLICT WITH, AND ARE THUS PREEMPTED BY, FEDERAL SECURITIES LAW.

The parties all agree on the basic federal preemption rules that govern this case. First, the Supremacy Clause of the U.S. Constitution makes federal law "the supreme Law of the Land." U.S. Const., art. VI, cl. 2. Consequently, federal law preempts state laws that "interfere with, or are contrary to the laws of Congress." *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 211 (1824). Second, "[f]ederal regulations issued by an agency in the scope of its congressionally-delegated authority are included among the 'Laws of the United States' which can preempt state law." *Credit Suisse*, 400 F.3d at 1128 (citing *City of New York v. FCC*, 486 U.S. 57, 63-64 (1988)); *see also Hillsborough Cnty v. Automated Med. Labs., Inc.*, 471 U.S. 707, 713 (1985) ("We have held repeatedly that state laws can be pre-empted by federal regulations as well as by federal statutes."). Third, SEC-approved SRO rules likewise "have preemptive force over conflicting state law," as SEC approval reflects the agency's determination that the rule "promote[s] the federal objectives of the Exchange Act." *Credit Suisse*, 400 F.3d at 1121, 1131 (citing 15 U.S.C. § 78s(b)(2)).

This appeal boils down to a dispute over whether Plaintiffs' state-law claims under California Labor Code § 450 are preempted because they are in "actual

conflict" with federal securities law, as implemented through SEC regulations and SRO rules. *Altria Group v. Good*, 555 U.S. 70, 76-77 (2008) ("Pre-emptive intent may … be inferred … if there is an actual conflict between state and federal law."). Every court to address this issue to date has held that the claims are preempted. As relevant here, such a conflict can manifest itself in either of two related ways. The first is "where it is impossible for a private party to comply with both state and federal law." *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000) (alterations and internal quotation marks omitted). The second is "where under the circumstances of a particular case, the challenged state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id.* (alterations and internal quotation marks omitted); *see also Chae v. SLM Corp.*, 593 F.3d 936, 943 (9th Cir. 2010).

The district court correctly concluded that both species of conflict preemption—impossibility and obstacle preemption—preempt claims seeking to apply Labor Code § 450 to prohibit Morgan Stanley's method of enforcing federal securities laws. We address each basis in turn.

A. Simultaneous Compliance With Labor Code § 450 and NYSE Rule 407(b) Is Impossible.

It can't be done. Labor Code § 450 (at least as Plaintiffs interpret it) cannot be reconciled with NYSE Rule 407(b). It is impossible. Simple logic compels that conclusion. *See infra* § I.A.1. So does this Court's precedent. *See infra* § I.A.2.

Plaintiffs' various efforts to harmonize their state-law theory with federal law are unpersuasive. *See infra* § I.A.3.

1. Plaintiffs' state-law claims are irreconcilable with federal law as a matter of simple logic.

Federal law, embodied in NYSE Rule 407(b), is as unequivocal as it is clear: No employee of a member firm may "establish or maintain any securities or commodities account" outside the firm "without the prior written consent of another person designated by the [firm] … to sign such consents." Packed into that simple proscription are three interdependent corollaries. ***Corollary 1*****:** It is illegal for an employee of a member firm to open an outside securities account without securing the firm's written consent. ***Corollary 2*****:** A member firm *must* adopt a policy prohibiting an employee from opening an outside account without securing the firm's written consent. ***Corollary 3*****:** The member firm must make a *reasoned decision* as to when to grant consent and when to withhold it. *See* NYSE Information Memo No. 09-50, 2009 WL 3615042, at *1 (Oct. 30, 2009) (noting that, pursuant to Rule 407, firms "must maintain reasonable and effective … written procedures for pre-approving requests to open or effect a transaction in [employee] accounts"). A law that required firms to grant every request to open outside accounts as a matter of course would necessarily prevent the meaningful exercise of consent that federal law contemplates. "Consent," after all, presupposes a voluntary, discretionary choice. *See Oxford English Dictionary*

Online (defining "consent" as a "[v]oluntary agreement to or acquiescence in what another proposes or desires; compliance, concurrence, permission"), *available at* http://www.oed.com.

Plaintiffs thus invoke California law in a way that directly contradicts Rule 407(b). California Labor Code § 450(a) provides that no employer may "compel or coerce any employee … to patronize [the] employer, or any other person, in the purchase of any thing of value." Plaintiffs interpret that provision to mean that Morgan Stanley may not require employees to keep their personal trading accounts in-house (at least if the accounts are subject to the firm's normal fees), for that would amount to "compel[ing] or coerc[ing]" them "to patronize" Morgan Stanley "in the purchase of" brokerage services. BER 1487. At least one group of Plaintiffs takes the position to its furthest possible extreme, by insisting that Morgan Stanley was not allowed to place special restrictions on employee trading activities even for an employee who was under federal investigation for insider trading. *See* SER 9. Plaintiffs insist that Morgan Stanley can satisfy its obligations under federal law without requiring "express prior written approval," "simply [by] permitting its employees to maintain outside accounts subject to reporting their trading activity to their employer." BER 1487; *Hanson* Br. at 22. In short, they believe that under California law, Morgan Stanley should require *notice* of outside brokerage accounts, not advance *consent*.

The two rules cannot coexist. Rule 407(b) requires more than notice; it requires "consent." The SEC left no doubt about the distinction, emphasizing that the rule requires employees to "obtain their employers' written approval (*rather than notification*) before entering into private securities transactions." Notice of Rule Change, 67 Fed. Reg. 54,006 (Aug. 13, 2002) (emphasis added). Thus, as the district court observed, a "policy that requires employees merely to provide notice of their personal outside trading accounts"—without also securing consent—"would violate Rule 407(b)." HER 12. Employees either have a right to maintain outside accounts without first obtaining employer approval (per Labor Code § 450) or they do not (per Rule 407(b)). Conversely, employers either have the responsibility to determine whether to grant or withhold consent case by case (per Rule 407(b)) or they do not (per Labor Code § 450). It cannot be both. "The question for 'impossibility' is whether the private party could independently do under federal law what state law requires of it." *Pliva, Inc. v. Mensing*, 131 S. Ct. 2567, 2579 (2011). This is a classic scenario in which "compliance with the state law prevents compliance with the federal law," which means that simultaneous compliance with both laws is impossible. *Golden Nugget, Inc. v. Am. Stock Exchange, Inc.*, 828 F.2d 586, 588 (9th Cir. 1987); *see also Geier v. Am. Honda Motor Co.*, 529 U.S. 861, 873 (2000) (describing "a case of impossibility" as one "in which state law penalizes what federal law requires").

Plaintiffs miss this basic point by arguing that "none of the NYSE Rules *require* employee brokerage accounts be kept solely in-house," *Hanson* Br. at 17 (emphasis in original); *see also id*. at 20-21, and that "[t]he existence of outside accounts plainly does not conflict with" Rule 407(b), *Bloemendaal* Br. at 33. They are focusing on the wrong conflict. They mistakenly seem to think that, if a state law says, "Firms *must* allow outside accounts," the only contrary federal law would be one that says, "Firms must *not* allow outside accounts." But a state law that requires firms to allow outside accounts also effectively says, "Outside accounts are a matter of right, *not* consent, and firms thus *cannot* exercise discretion." This directly contradicts a federal law that says, as Rule 407(b) does, "Outside accounts are a matter of consent, *not* right, and firms thus *must* exercise discretion." The two laws are irreconcilable.

To illustrate, federal law prohibits patients from acquiring certain drugs without first securing a doctor's consent (i.e., a prescription). Suppose California passed a statute granting patients a right to acquire a particular drug—say, Ritalin—with or without a doctor's consent (i.e., over the counter). By Plaintiffs' logic, the California law is fine, because federal law does not *prohibit* doctors from granting patients' Ritalin requests—or, to adapt Plaintiffs' formulation, "the existence of patients with Ritalin does not conflict with federal law." That is obviously wrong. The state law authorizes patients to do precisely what federal

law forbids—namely, obtain Ritalin without a doctor's permission. Likewise, the state law precludes doctors from doing what federal law requires—namely, acting as a gatekeeper to prevent patients from obtaining Ritalin when the doctor would disapprove. Simultaneous compliance is impossible. That is precisely what Plaintiffs' claims do here, and they are equally invalid.

2. This Court's precedent compels a finding of impossibility.

As the district court observed, this Court has already invalidated a state law based on a very similar conflict—rejecting the very same analysis Plaintiffs proffer here. HER 11-12. The question in *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005), was whether the NASD's arbitration rules preempted certain California Ethics Standards. Under the NASD rules, the NASD's Director of Arbitration was *permitted* to remove an arbitrator who neglected to make a required disclosure. The NASD rules did not, however, require the Director to do so. Under the California Ethics Standards, an arbitrator's failure to make a necessary disclosure meant that the arbitrator was automatically disqualified. In other words, California law stripped the Director of the discretion to make that judgment. *See Credit Suisse*, 400 F.3d at 1133-34.

The party opposing preemption in *Credit Suisse* took a position that was in all relevant respects identical to Plaintiffs' position here: He asserted that federal law did not conflict with state law because federal law permitted disqualification,

and state law merely provided that disqualification would be *the only* acceptable option in California arbitrations. There, as here, the argument was that federal law did not categorically prohibit that which California law required. Rejecting that argument, this Court held that it was indeed "physically impossible for a party to simultaneously comply" with the state and federal disqualification rules. *Id*. at 1134. The application of California law, this Court explained, "would strip the [NASD] Director of Arbitration of his federally-recognized obligation to make a determination whether an arbitrator should in fact be disqualified." *Id*. "If the NASD Director exercise[d] his discretion under the NASD Code by refusing to dismiss an arbitrator that failed to make a required disclosure, the Director [would] violate[] the California Ethics Standards' mandatory disqualification provision." *Id*. at 1133. Alternatively, if the Director followed the California rules, "he [would] effectively forfeit[] his discretionary authority under the NASD code." *Id*. The Supremacy Clause, this Court concluded, does not tolerate that sort of "catch-22." *Id*.

Plaintiffs' perfunctory attempts to distinguish *Credit Suisse* are unpersuasive. The *Hanson* Plaintiffs correctly point out that "preemption was found in [*Credit Suisse*] because of a *direct conflict* between the varying state and federal sets of rules." *Hanson* Br. at 27. But that is no distinction. As the district court correctly concluded, Plaintiffs' claims here present precisely the same

"catch-22"—for all the reasons discussed above—and deserve the same fate. HER 11.

Beyond that, Plaintiffs simply note that the SEC had intervened in *Credit Suisse* to express its view that state law conflicted with federal law. This Court, however, did not even mention the SEC's position in its discussion of the conflicting state and federal disqualification rules. There was no need to. As in this case, the impossibility of simultaneous compliance was evident from the provisions themselves. The Court relied on the SEC's litigation position only in its separate holding (addressed *infra* at 52-54) that California's arbitration disclosure rules stood as an obstacle to the accomplishment of the objectives embodied in the NASD arbitration rules. *See Credit Suisse*, 400 F.3d at 1135-36. And even there, the Court followed the SEC's position only after determining that it was "well-supported by the record." *Id*. at 1136. Nowhere did the Court indicate that it would have reached a different result had the SEC been too busy to file an amicus brief. The very suggestion conflicts with the Supreme Court's admonition that it is incumbent on the reviewing court to "perform[] its own conflict determination, relying on the substance of state and federal law and not on agency proclamations of pre-emption." *Wyeth v. Levine*, 129 S. Ct. 1187, 1201 (2009).

3. Plaintiffs fail to reconcile their state-law theory with federal law.

Plaintiffs' central theme is that Morgan Stanley "has already successfully followed both California law and the SRO rules for at least a year without running afoul of its duty to supervise its employees' trading activities." *Hanson* Br. at 28; *see also Bloemendaal* Br. at 33-34. Specifically, they point out that Morgan Stanley revised its employee trading policy to provide that "[e]mployees working or residing in California may maintain their Employee Securities Accounts outside of the Firm, subject to disclosure … and arrangement for duplicate confirmations and statements to be provided to Morgan Stanley." BER 163 n.1. From this fact, Plaintiffs leap to the conclusion that "it is indeed physically possible to comply" with both Labor Code § 450 and NYSE Rule 407(b). *Hanson* Br. at 21.

All that Plaintiffs have managed to demonstrate is that Morgan Stanley has capitulated to the threat of crushing liability under state law. But the capitulation does nothing to overcome the direct conflict between federal and state law. As was the case before Morgan Stanley's capitulation, federal law still prohibits employees from "establish[ing] or maintain[ing] any securities or commodities account" outside the firm "without the prior written consent of another person designated by the [firm] … to sign such consents." NYSE Rule 407(b). To comply with state law, Morgan Stanley had to start giving "consent" as a matter of course, foregoing its federal right to make discretionary judgments. Far from proving that there is no

conflict, the fact that Morgan Stanley felt compelled to give up its preferred compliance policy only highlights the inconsistency between state and federal law.

Plaintiffs apparently rely on the absence of a federal enforcement action against Morgan Stanley as evidence that state and federal law can be "successfully" reconciled. Morgan Stanley has taken extraordinary care to ensure that, despite the constraints purportedly imposed by California law, it does not end up on the wrong end of a FINRA or SEC disciplinary proceeding. While Morgan Stanley's efforts may suffice to avoid a federal penalty, they do not in any way lessen the intractable nature of the conflict. By way of analogy, suppose a federal environmental law gives companies several options for achieving at least a 10% reduction in pollution and directs them to choose the method that is least costly for them. And suppose the law imposes a penalty on companies that fail to meet the 10% benchmark. If a state law requires all companies to implement a particular expensive method that reduces pollution by exactly 10%, a company can comply with that state law and not face a federal penalty. But the state and federal laws nevertheless impose contradictory, irreconcilable demands. Labor Code § 450 and Rule 407(b) are equally incompatible. The former precludes firms from making decisions about employee trading accounts in the manner the latter expects.

If anything, Morgan Stanley finds itself in a situation even more problematic than the one described in the environmental law hypothetical. While Morgan

Stanley believes that its current compliance policies are sufficient to stave off a federal enforcement action, there are no guarantees. Federal regulators routinely take firms to task for failing to do enough to guard against insider trading and other abuses and, in particular, for failing to conduct adequate surveillance of employee trading accounts. Just recently, the SEC penalized a securities firm for too liberally granting its employees permission to open outside trading accounts. *See In re Janney Montgomery Scott LLC*, Exh. Act Rel. No. 64,855, 2011 WL 2680794 (July 11, 2011). Like Morgan Stanley's original policy, the "stated policy" of the firm in that action was "that all employees must keep their trading accounts at [the firm]." *Id.* at *5. The firm's compliance manager, however, admitted that the firm had been "granting permission to keep accounts away from the firm … 'too frequent[ly].'" *Id.* The SEC faulted the firm for adopting "this practice" because it "made monitoring of improper trading activity more difficult than if the accounts were required to be kept at the firm." *Id*. The SEC concluded that the firm had willfully violated Exchange Act § 15(g) by failing to maintain policies "reasonably designed, given the nature of its business, to prevent the misuse of material, nonpublic information." *Id.* at *6.

Like the SEC, the SROs have also faulted firms for failing to "maintain adequate procedures and controls" for "approval and review of employee-trading accounts held outside the firm in violation of NYSE Rule 407." *Credit Suisse First*

Boston LLC, NYSE Hearing Panel Decision 06-16, 2006 WL 1975753, at *1 (May 10, 2006). In a case that is far too close for comfort, a major securities firm approved an employee's request to maintain outside accounts. *Id.* The employee then improperly transferred more than $3 million in client funds to those outside accounts. The SRO penalized the firm for departing from its general policy "not [to] permit employees to maintain brokerage accounts at other institutions," noting that "the accounts did not satisfy [the firm's] criteria for outside accounts." *Id*. at *4 & n.4. In determining how harshly to penalize the firm, the NYSE noted as a mitigating factor that the firm had subsequently "implemented more limitations upon the use of outside accounts." *Id*. at *6. The application of § 450 to employee trading accounts means that Morgan Stanley no longer has that compliance option, even when it has reason to suspect employee malfeasance, as was the case with Plaintiff Notrica. In short, the precarious position in which Morgan Stanley now finds itself underscores the intractable conflict between Labor Code § 450 and federal securities law.

Beyond the argument about Morgan Stanley's change in practice, Plaintiffs offer two other creative suggestions for reconciling Labor Code § 450 and NYSE Rule 407(b). First, the *Hanson* Plaintiffs—but not the *Bloemendaal* Plaintiffs—make the puzzling assertion that dual compliance is possible because Morgan Stanley "could easily withhold consent in certain situations without running afoul

of [§ 450]." *Hanson* Br. at 20. Specifically, they suggest, ever so tentatively, that "withholding consent to an employee who had displayed a pattern of abusing outside accounts or was suspected of insider trading would probably not be considered compulsion or coercion." *Id*. But if denying consent to open an outside brokerage account is impermissible "coerc[ion]" under § 450, then it is impermissible regardless of the basis on which the consent is withheld. California law provides for no "abusive pattern" exception.

Moreover, this argument undermines the entire justification for a class action premised on a violation of § 450. If § 450 allows Morgan Stanley to restrict outside trading accounts based on employees' individual circumstances, then Plaintiffs could not possibly proceed as a class. Indeed, right off the bat, the *Hanson* Plaintiffs would rule out relief for one of the two named Plaintiffs in *Bloemendaal*, Mr. Notrica, who was under investigation for insider trading during his tenure with the firm. That is probably why even the *Hanson* Plaintiffs offer only the most tepid suggestion of what the law "probably" would be. *Hanson* Br. at 20. The *Hanson* Plaintiffs also fail to offer any suggestion as to what standards and whose judgment would apply in determining whether consent was justifiably withheld.

For their part, the *Bloemendaal* Plaintiffs—but not the *Hanson* Plaintiffs—contend that Morgan Stanley can comply with both state and federal law by

requiring employees to use in-house accounts but giving the accounts away for free—or possibly charging, but only at cost. *See Bloemendaal* Br. at 3, 29, 33 & n.15. As an initial matter, Plaintiffs' proposal would not avoid the threat of liability under California law. If Morgan Stanley were to sell services at a discount, it could still be accused of "coercing" its employees to "patronize [their] employer … in the purchase of [some]thing of value." Cal. Labor Code § 450; *cf. Young v. Polo Retail, LLC*, No. C-02-4546 VRW, 2007 WL 951821, at *1-2 (N.D. Cal. Mar. 28, 2007) (approving settlement in class action alleging that defendants violated § 450 by coercing plaintiff employees to buy the defendants' apparel at a discounted price). Morgan Stanley would likely face the same accusation even if it were to offer in-house accounts and trading services for free. After all, whether or not employees must pay to make trades, they could still assert than an in-house account requirement forces them patronize Morgan Stanley in the purchase of something of value—namely, stock.

In any event, whatever the status of Plaintiffs' just-give-it-away policy under state law, the policy would still clash with federal law. Federal law prohibits the use of outside brokerage accounts without "prior written consent" and requires firms to make an unfettered decision as to whether to grant consent. Obviously, a California law would be preempted if it required Morgan Stanley to pay a $1,000 fine every time it denied consent. The same goes for any California law that

penalizes a firm for complying with its supervisory responsibilities under federal law. That is exactly what Plaintiffs' proposal would do. Brokerage services are not cost-free. Requiring Morgan Stanley to allow its employees to trade on the house would result in significant financial losses for the firm and, moreover, would "undermin[e] [Morgan Stanley's] policy to discourage short-term, speculative trading." BER 1063; *see also* BER 161. Because a state law along these lines would unquestionably encumber the firm's exercise of its discretion, it is just as improper as one that outright prohibits federal compliance and imposes fines on violators. Indeed, at some point, a burden becomes so onerous that it might as well be couched as a prohibition. *See Nathan Kimmel, Inc. v. DowElanco*, 275 F.3d 1199, 1205 (9th Cir. 2002) (the imposition of burdens not contemplated under the federal scheme "militate[s] in favor of" concluding that state law is "impliedly preempted"); *cf. Davis v. FEC*, 554 U.S. 724, 738-39 (2008) (invalidating a law that required candidates to "shoulder a special and potentially significant burden if they ma[d]e th[e] choice" to self-finance their campaigns, even though the law did not prohibit self-financing).

That is the point Plaintiffs miss when they analogize their give-it-away proposal to overtime requirements or meal periods. *See Bloemendaal* Br. at 35-36. Obviously, the state is permitted to impose certain financial burdens on employers. The particular examples Plaintiffs offer are valid because there is nothing in

federal law—no statute or regulation—that makes it a priority to give employers the unfettered latitude to require extended workdays or to starve employees. In contrast, because there is a federal imperative to grant employers the latitude to design the most effective compliance program, and specifically to restrict outside accounts, a state cannot validly constrain that latitude.

In short, it is simply not Plaintiffs' place to rewrite federal regulations and restrict Morgan Stanley's discretion to act. But even if it were, none of Plaintiffs' ideas about how to design a better enforcement policy would enable Morgan Stanley simultaneously to meet its state and federal obligations.

B. Plaintiffs' Claims Stand as an Obstacle to the Accomplishment of Significant Federal Objectives.

Even if simultaneous compliance with Labor Code § 450 and NYSE Rule 407(b) were technically "possible," Plaintiffs' claims fail for the independent reason that their reading of § 450 "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines*, 312 U.S. at 67. "[A]ny state legislation which frustrates the full effectiveness of federal law is rendered invalid by the Supremacy Clause." *Perez v. Campbell*, 402 U.S. 637, 652 (1971). As the district court recognized, Plaintiffs' interpretation of Labor Code § 450 "undoubtedly frustrates" the federal objectives embodied in the Exchange Act and its accompanying regulatory regime. HER 11. It does so in two related ways: (1) by undermining the flexibility that Congress and the various regulators

granted to broker-dealers to determine how best to combat securities law violations; and (2) by banning a federally approved compliance method—namely, restricting employees' use of outside trading accounts—that Congress and regulators knew to be widely used and uniquely effective. *See infra* § I.B.1. Under the precedents of both this Court and the Supreme Court, federal law preempts this interference with federal objectives. *See infra* § I.B.2.

1. State law frustrates the accomplishment of federal objectives in two ways.

As described above, Congress enacted the ITSFEA in the wake of a series of Wall Street scandals involving rampant insider trading by employees at all levels. *See supra* at 1. Viewing those scandals as the outgrowth of institutional failures, Congress concluded that investment firms "must do more to share in the responsibility for policing th[e securities] markets." H.R. Rep. 100-910, at 15. Accordingly, Congress ordered firms to act as the first line of defense in preventing insider trading and detecting it and curing it when it happened. At the foundation of the statutory and regulatory structure scheme are two premises, both of which would be demolished by Plaintiffs' application of California law.

Premise 1: Flexibility and autonomy. The first premise is that the most effective compliance method varies from one firm to the next, and each firm is best situated to decide for itself how to protect against and detect securities law violations. This first premise is codified in the statutory command that "[e]very

registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, *taking into consideration the nature of such broker's or dealer's business*, to prevent the misuse … of material, nonpublic information" by employees. 15 U.S.C. § 78o(g) (emphasis added).

As is evident from the statute, Congress decided not to "set forth specific policies and procedures that are required of every broker-dealer." H.R. Rep. 100-910, at 21. Instead, Congress recognized "that the question of what policies and procedures are reasonable for a particular firm may involve consideration of the differing business operations, organizational structure, scope and nature of a firm's business." *Id*. at 21-22; *see also id*. at 38 (same); 134 Cong. Rec. S17218 (daily ed. Oct. 21, 1988) (statement of Sen. Proxmire) ("[T]he policies and procedures appropriate to different broker-dealers will depend on the nature of their businesses and the circumstances in which they conduct business and may differ from case to case."). It therefore embraced the SEC's view as to "the importance of providing flexibility to an institution to tailor its policies and procedures to fit its own situation." H.R. Rep. 100-910, at 22.

In administering this statutory command, the SEC has repeatedly emphasized the same point—that firms must retain the flexibility and autonomy to adopt and enforce "policies and procedures that take into account the special circumstances of their particular businesses and organizations." *In re Gabelli &*

Co., Inc., Exch. Act Rel. No. 35,057, 1994 WL 684627, at *4 (Dec. 8, 1994). As the SEC put it, "[t]he requirement that a broker or dealer implement and maintain policies and procedures consistent with the nature of its business 'is critical to effectively preventing the misuse of material, nonpublic information.'" *In re Martinez*, Exh. Act Rel. 57,755, 2008 WL 1913369, at *4 (May 1, 2008) (quoting *In re Gabelli & Co.*, 1994 WL 684627, at *4); *In re Goldman, Sachs & Co.*, Exc. Act Rel. No. 48,436, 2003 WL 22056978 (Sept. 4, 2003) ("The securities industry has long been aware of the need for effective compliance policies to guard against the risk of misuse of material nonpublic information, and the need to tailor those policies to the specific activities of the individual firm."). "[F]lexibility is necessary to permit diverse institutions to tailor their policies to fit their particular business conditions." SEC Division of Market Regulation Report at 1.

SROs, too, have emphasized the same premise. FINRA rules, for example, require the chief executive of each member firm to certify that the firm has taken steps to implement policies "reasonably designed to achieve compliance" "in light of the nature of [the firm's] businesses and the laws and rules applicable thereto." FINRA Rule 3130(b), 3130.03. The rules describe it as "critical" that firms "understand the importance of employing comprehensive and effective compliance policies and written supervisory procedures." FINRA Rule 3130.03; *see also* NASD Rule 3010(a) (requiring firms to maintain systems "reasonably designed to

achieve compliance with applicable securities laws and regulations" that include, "at a minimum," certain enumerated features). Similarly, NYSE Rule 342.21(a) instructs firms to subject employee trades "to review procedures that the [firm] … determines to be reasonably designed to identify trades that may violate" federal law.

Plaintiffs invoke Labor Code § 450 to constrain the flexibility that is critical to the federal regulatory system. The application of Labor Code § 450 would prevent a firm from restricting outside trading accounts even if the firm is sure that such restrictions are the most effective way to guard against securities violations—and, indeed, even if it concludes, based on "consideration of the [firm's] differing business operations, organizational structure, scope and nature of [its] business," H.R. Rep. 100-910, at 22, that they are the *only* reasonable way to guard against securities violations.

Plaintiffs' approach directly obstructs the flexibility and autonomy Congress intended to vest in securities firms. Congress subjected those firm-specific judgments to the oversight of federal regulators—such as the SEC and the SROs. As the district court understood, Congress did not envision—and plainly did not want—securities firms adapting their supervisory policies to the whims of plaintiffs' lawyers or former employees wielding idiosyncratic and vague state laws that were not even designed with federal enforcement policies in mind. *See*

HER 12 (explaining that it is not "the Court's place to disregard Congress's intent and impose a specific policy on [Morgan Stanley]").

Premise 2: Outside account restrictions as an option. Even while declining to prescribe exactly what each firm must do to ensure compliance, Congress and the various regulators plainly contemplated that certain options would be available to firms. In passing the legislation, Congress described certain "minimum" components of an adequate supervisory system, including "employment policies such as those *requiring personnel to conduct their securities trading through in-house accounts* or requiring that any trading in outside accounts be reported expeditiously to the employing firm." H.R. Rep. 100-910, at 22 (emphasis added). Congress was undoubtedly aware—and the federal regulators certainly are—that "almost all firms" chose the first option. SEC Division of Market Regulation Report at 8. The district court was correct in noting that "[l]egislative history shows that Congress expressly approved and expected firms to adopt this type of policy." HER 10. The SROs, for their part, have similarly expected that this device would be available as an option. As we have seen, the NYSE outright dictated, in Rule 407(b), that employees cannot maintain outside accounts without their employers' "prior written consent."

Plaintiffs' invocation of Labor Code § 450 clashes with the intentions of Congress and the regulatory agencies to leave this compliance option available to

firms. Practically every firm in the industry has adopted this compliance option precisely because most firms deem it to be the most effective at preventing and detecting abuses. As explained more fully above, monitoring outside accounts is nowhere near as effective as prohibiting them—from the perspective of the promptness with which the information is available, the ease with which it can be analyzed, the convenience of contacting witnesses, and the speed and certainty with which an improper transaction can be reversed. *See supra* at 13-15; BER 67-68. To ban brokerage firms from exercising a federally blessed option that the vast majority of them consider to be uniquely effective at combating securities fraud is to severely frustrate federal objectives.

* * *

Only by ignoring all these indicia of federal intent and objectives can Plaintiffs assert that ITSFEA's legislative and regulatory history shows a "lack of actual conflict" between federal law and Labor Code § 450. *Hanson* Br. at 21. In so arguing, Plaintiffs observe that "various regulations have acknowledged that an employer may monitor insider trading by its employees by monitoring their outside brokerage accounts." *Bloomendaal* Br. at 36. But these regulations simply confirm that *if* a firm chooses to allow outside trading accounts, it *might* be able to meet its federal obligations by "requiring that any trading in [those] accounts be reported expeditiously to the employing firm." H.R. Rep. 100-910, at 22. It is

evident that neither Congress nor the various regulators intended for this to be the *only* option available to firms. The legislative and administrative record contains not the slightest hint that Congress, the SEC, or the SROs—all of which emphasized the need for flexibility—believed that states and opportunistic plaintiffs would be entitled to prohibit the most prevalent supervisory option. Allowing states to meddle in the compliance decisions of firms by precluding them from enforcing an in-house account requirement is fundamentally at odds with the federal design. *See Chae*, 593 F.3d at 946 ("Federal regulators often include calculated flexibility within their programs without violating congressional intent to have a federal program uniformly control.").

Plaintiffs also rehash the same arguments from the impossibility prong above, that (1) Morgan Stanley's capitulation proves that state law does not pose any obstacle to the achievement of federal interests; and (2) the firm can advance all the relevant federal policies by requiring its employees to open in-house accounts on the house. They are wrong here, as well, and for similar reasons. *See supra* at 32-39. The statute and related federal regulations encourage securities firms like Morgan Stanley to adhere to the supervisory policies that they determine to be most effective at protecting investors in light of the firm's specific circumstances—not to capitulate to outside pressures and adopt policies that they consider to be inferior. And the fact that Morgan Stanley chose to retreat from its

preferred policy in favor of allowing outside accounts—rather than give away thousands of free in-house accounts and an unlimited number of free trades—only demonstrates just how burdensome Plaintiffs' give-it-away proposal is. If, as we have demonstrated, a state may not directly penalize a supervisory option that is important to the federal regulatory regime, it cannot condition that option on extravagant requirements that make the option untenable.

Plaintiffs offer various other proposals for how a securities firm might tailor its supervisory policies to Plaintiffs' vision of state law. *Bloemendaal* Br. at 37. If Plaintiffs started their own brokerage firm, they would be welcome to try out any of these ideas, or, as they propose, give away their services. But federal law does not subject Morgan Stanley to Plaintiffs' whims. Federal law gives Morgan Stanley the right to select the supervisory measures it deems best, subject to oversight from *federal* regulators.

Plaintiffs' proposals, moreover, are poor ones. To take just one example, Plaintiffs propose that Morgan Stanley should have "require[d] pre-clearance of all employee trades in outside accounts" instead of prohibiting outside accounts all together. *Id.* A pre-clearance requirement by no means remedies the inherent compliance difficulties associated with outside accounts. Morgan Stanley would have to rely on employees to self-report, and employees presumably would be least likely to disclose the transactions that are most problematic. To the extent

employees do self-report, Morgan Stanley would face the logistical nightmare of trying to process requests in a timely fashion. Employees, moreover, might well view a blanket pre-clearance policy as a coercive attempt to force them to shift their accounts in-house, particularly if the clearance process gets drawn out and they are unable to act as their investments plummet in value. This proposal, and each of the others, confirms Congress's wisdom in entrusting these compliance decisions to the brokerage firms themselves rather than delegating them to committees of plaintiffs' lawyers and disgruntled former employees.

2. The precedents confirm that the state law here is an impediment to achieving federal objectives.

These two features of the regulatory regime—the imperative to grant the firms the flexibility and autonomy to design their own enforcement regimen and the intention to embrace restrictions on outside accounts—are dispositive under the precedents of both the Supreme Court and this Court.

The interplay between two Supreme Court cases—*Geier v. American Honda Motor Co.*, 529 U.S. 861 (2000), and *Williamson v. Mazda Motor of America, Inc.*, 131 S. Ct. 1131 (2011)—brings the point into stark relief. Both cases involved the preemptive scope of versions of the Federal Motor Vehicle Safety Standard (FMVSS) 208. *Geier* involved the 1984 version, which "required auto manufacturers to equip some but not all of their … vehicles with passive restraints." 529 U.S. at 864-65. The question was whether FMVSS 208 preempted

"a state common-law tort action in which the plaintiff claim[ed] that the defendant auto manufacturer, who was in compliance with the standard, should nevertheless have equipped [its] automobile with airbags." *Id*. at 865. The Court concluded that the state tort suit was preempted. Critical to that holding was the observation that the administrative record "ma[d]e clear that the standard *deliberately provided the manufacturer with a range of choices* among different passive restraint devices." *Id*. at 875 (emphasis added). The agency intended to foster "a *gradual* phase-in of passive restraints" to help "promote public acceptance" and give manufacturers an opportunity to "develop information about the comparative effectiveness of different systems." *Id*. at 879. Because "a rule of state tort law" would have effectively "required manufacturers of all similar cars to install airbags rather than other passive restraint systems," it "would have presented an obstacle to the variety and mix of devices that the federal regulation sought," and thus to "important … federal objectives." *Id*. at 881-82.

In *Williamson*, the Supreme Court confronted a more recent version of FMVSS 208, adopted after manufacturers and regulators had amassed abundant safety information, thus making it far less important to encourage a variety of restraints. The new version provided that federal law would require a seat belt in rear middle seats, but it was agnostic as between a simple lap belt or a lap-and-shoulder belt. The Court held that this regulation did *not* preempt "a [state-law

action] that, if successful, would deny manufacturers a choice of belts for rear inner seats by imposing tort liability upon those who choose to install a simple lap belt." 131 S. Ct. at 1134. The difference in result was all about how important (or unimportant) it was to the agency to grant car makers the choice. The Court explained that, in *Geier*, "the regulation's history, the agency's contemporaneous explanation, and its consistently held interpretative views indicated that the regulation sought to maintain manufacturer choice in order to further significant regulatory objectives." *Id*. at 1139; *see also id*. at 1136 ("At the heart of *Geier* lies our determination that giving auto manufacturers a choice among different kinds of passive restraint devices was a *significant objective* of the federal regulation." (emphasis in original)). In *Williamson*, after extensively examining all the same indicia of intent—"the regulation's history, the agency's contemporaneous explanation, and its consistently held interpretive views"—the Court concluded that "these same considerations indicate[d] the contrary," that "providing manufacturers with this seatbelt choice [was] not a significant objective." *Id*. at 1139, 1134.

Plaintiffs fixate on *Williamson* with scarcely a nod to *Geier*, as if the Supreme Court had never incorporated *Geier*'s holding and logic directly into its

analysis of the sequel.[6] As Plaintiffs acknowledge, the question, both before and after *Williamson*, is "whether the choice itself was 'a significant objective of the federal regulation.'" *Bloemendaal* Br. at 34 (quoting *Williamson*, 131 S. Ct. at 1133); *Hanson* Br. at 19. On that score, this case is far more analogous to *Geier* than to *Williamson*. In fact, the legislative and administrative record in this case is even more definitive on the goal of providing choice than in *Geier*. Here we have a congressional command that each firm is to decide for itself, along with a clear indication that Congress expected that some firms would choose to prohibit outside brokerage accounts—both of which were missing in *Geier*. Here we have regulators echoing how "critical," *In re Martinez*, 2008 WL 1913369, at *4, or "foundation[al]" that autonomy is, FINRA Rule 3130.03, and indicating that they, too, intend to allow (or even require) restrictions on outside employee trading accounts as one of the tools in firms' supervisory toolkits. As in *Geier,* but unlike in *Williamson*, federal law undoubtedly seeks "to maintain [broker-dealer] choice in order to further significant regulatory objectives." *Williamson*, 131 S. Ct. at

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[6] Plaintiffs evidently concede that *Williamson* does not in any way undermine the district court's holding with respect to impossibility. *Williamson* did not involve a claim of impossibility, but only the second brand of conflict preemption—whether the state law served as an impediment to achieving a federal objective. Obviously, where it is impossible to satisfy both state law and federal law, that is the end of the inquiry, and preemption does not revolve around an assessment of how important the agency considered a particular choice to be.

1139. Because Plaintiffs' application of state law would eliminate an enforcement option that Congress and the federal regulators all intended to leave intact, their claims stand as an obstacle to fulfillment of those federal objectives and are therefore preempted.

To this, Plaintiffs' main response is that "the *key* objective of the SRO rules is to prevent insider trading" and "[t]he options have only to do with how." *Hanson* Br. at 25 (emphasis added). The same, of course, could be said about *Geier*, where "the key objective" of the seat belt standards was to save lives, and "[t]he options have only to do with how." But as Plaintiffs elsewhere acknowledge, under *Geier* and *Williamson*, the question is not what *the* overarching objective of the entire federal scheme is, but only "whether the choice itself was 'a *significant* objective of the federal regulation.'" *Bloemendaal* Br. at 34 (quoting *Williamson*, 131 S. Ct. at 1133) (emphasis added); *Hanson* Br. at 19. Here, the objective or affording firms choice was at least "significant." Moreover, as previously explained, *see supra* at 13-15, 45, restricting outside accounts is an especially effective way to serve the ultimate federal objective of protecting investors from abuses perpetrated by market insiders.

Confirming that *Geier* is the closer match to this case, this Court, too, has found preemptive conflicts in several analogous cases—all of which follow the same principles the Supreme Court laid out in *Geier* and *Williamson*. In *Credit*

Suisse, after nullifying the California Ethics Standards for arbitrator disqualification on an impossibility theory, *see supra* at 29-30, this Court proceeded to consider whether federal law also preempted the California Ethics Standards for arbitrator disclosures. The Court observed that it was possible for arbitrators to comply with both federal disclosure rules and the California standards, which simply mandated more extensive disclosures than the NASD rules. 400 F.3d at 1135 ("[A]n arbitrator that discloses all of the information required by the California Ethics Standards may go beyond the call of duty, but he does not violate any rule contained in the NASD Code."). But the Court determined that the California disclosure standards nevertheless interfered with an important congressional objective. In language equally applicable here, the Court explained that "permitting each state to regulate NASD arbitration procedures would create a patchwork of laws that would interfere with Congress's chosen approach of delegating nationwide, cooperative regulatory authority to the Commission and the NASD." *Id*. at 1135. The state law at issue in this case interferes with federal objectives far more directly than the California Ethics Standards at issue in *Credit Suisse*. While the California disclosure standards at least arguably supplemented the federal disclosure standards and advanced the goal of fair arbitration, Labor Code § 450 unquestionably frustrates key objectives of federal securities law. Yet, Plaintiffs do not even address this portion of *Credit*

Suisse (except with a cryptic notation that it is "*contra*" *Williamson*, presumably to indicate that this Court therefore should not follow its own precedent). *Hanson* Br. at 19.

This Court also addressed the preemptive scope of federal securities law in *Whistler Investments, Inc. v. Depository Trust & Clearing Corp.*, 539 F.3d 1159 (9th Cir. 2008). The plaintiff corporation there brought state-law claims against a securities clearing agent that allegedly drove down the value of the plaintiff's stock by using certain share-borrowing practices. The clearing agent responded that the plaintiff's claims conflicted with SEC-approved rules, which allowed the agent to adopt those practices. This Court agreed with the clearing agent that the plaintiff's claims were indeed preempted because they were "inconsistent with [the Exchange Act's] purpose of allowing the [SEC] to regulate and control a national system for clearing and settling securities transactions." *Id*. at 1166. The Court reached this conclusion even though none of the relevant laws or regulations affirmatively *required* the clearing agent to use the particular borrowing practices the plaintiff challenged in its state-law suit.

This Court's precedents outside the securities context likewise support the district court's determination that Plaintiffs' Labor Code claims conflict with federal law. In one case, for example, this Court considered a local ordinance that required mail carriers "to obtain express consent from residents before crossing

their lawns in the course of mail delivery." *United States v. City of Pittsburg*, 661 F.2d 783, 784 (9th Cir. 1981). This Court held that the ordinance conflicted with a federal regulation authorizing mail carriers to "cross lawns while making deliveries if patrons do not object." *Id.* at 785. According to the Court, the local ordinance "frustrate[d] a major Congressional objective"—namely, "postal efficiency"—by restricting the ability of letter carriers to exercise their option to cross lawns as the federal regulation contemplated. *Id*. at 785-86. It was irrelevant that the federal regulation did not *require* letter carriers to cross lawns. What mattered was that it gave them the discretion to do so (unless a property owner affirmatively objected), and the local ordinance interfered with that discretion, just as Labor Code § 450 interferes with the discretion provided by federal securities law.

More recently, this Court considered a case in which a class of student borrowers asserted that their lenders violated California's unfair competition law by charging late fees. *See Chae v. SLM Corp.*, 593 F.3d 936 (9th Cir. 2010). The lenders defended on the ground that the borrowers' state-law claims conflicted with a Department of Education policy "permitting, but not requiring, lenders to charge late fees." *Id*. at 947. This Court agreed, explaining that the fact that federal law gives regulated parties "a measure of flexibility" "does not automatically mean that state law may operate freely." *Id*. After reviewing the statutory scheme, the Court determined that "Congress intended to subject [student

loan program] participants to uniform federal law and regulations." *Id*. As the Court saw it, "[i]f federal law permits late fees and gives up to sixty days for repayment, to say that state law prohibits late fees and requires a prompter repayment period is in conflict." *Id*. at 948. That analysis is equally apt here. *See also Nathan Kimmel, Inc. v. DowElanco*, 275 F.3d at 1207 (concluding that preemption was necessary where application of state law "would force [certain businesses] to ensure that their disclosures to the EPA would satisfy not only the standards imposed by that agency under federal law, but also the potentially heterogeneous standards propounded by each of the 50 States"); *Flamingo Indus. (USA) Ltd. v. U.S. Postal Serv.*, 302 F.3d 985, 997 (9th Cir. 2002) (holding state-law unfair business practice claims against Postal Service preempted because they posed an obstacle to "the Service's right to control the character and necessity of its purchases free from state constraint"), *rev'd on other grounds*, 540 U.S. 736, *relevant portions of opinion reinstated*, 366 F.3d 789 (9th Cir. 2004).

C. The Presumption Against Preemption Does Not Save Plaintiffs' Claims.

In an effort to tilt the preemption inquiry in their favor, Plaintiffs invoke "the presumption against preemption"—"the longstanding maxim that Congress does not cavalierly overrule state law." *Hanson* Br. at 13-14; *see also Bloemendaal* Br. at 17-20. The presumption does not change the outcome for several reasons.

First, Plaintiffs are seeking to pursue a state-law cause of action based on conduct that derives from the "inherently federal" relationship "between a federal agency and the entity it regulates." *Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S.341, 347 (2001). In *Buckman*, a medical device company asserted that federal law preempted state-law claims alleging that the company had made fraudulent misrepresentations to the Food and Drug Administration (FDA) during a device approval process. Agreeing with the company, the Supreme Court noted that the company's "dealings with the FDA were prompted by [federal law], and the very subject matter of [the company's] statements were dictated by the statute's provisions." *Id*. at 347-48. "Accordingly—and in contrast to situations implicating 'federalism concerns and the historic primacy of state regulation of matters of health and safety'—no presumption against pre-emption obtain[ed]." *Id*. at 348 (quoting *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996)).

Here, as in *Buckman*, it was federal law that precipitated the acts underlying Plaintiffs' state-law claim. Specifically, ITSFEA and its related SRO rules require broker-dealers to develop and maintain employee trading policies designed to guard against insider trading and other abusive practices, and Morgan Stanley adopted its policy for exactly that reason. Because Plaintiffs are challenging this federally prompted conduct, they cannot invoke the presumption against preemption. *See also Nathan Kimmel*, 275 F.3d at 1205 (declining, in light of

Buckman, to impose a presumption against preemption where plaintiff sought to bring a state-law claim alleging that the defendant had committed fraud against the EPA).

Second, and relatedly, "the presumption [against preemption] usually does not apply" "'when the State regulates in an area where there has been a history of significant federal presence.'" *Ting v. AT&T*, 319 F.3d 1126, 1136 (9th Cir. 2003) (quoting *United States v. Locke*, 529 U.S. 89, 108 (2000)). Although Labor Code § 450 is a law that applies to all employers, Plaintiffs here seek to apply it to a practice that is unique to federally regulated securities firms. Plaintiffs' assertion that states generally have broad powers to regulate employment relationships is thus beside the point. In the securities industry, federal regulation of the trading activities of broker-dealers and their employees is both significant and longstanding. While states play a supporting role in regulating abusive practices in the national securities markets, most regulation occurs at the federal level.[7] Accordingly, this case does not involve a circumstance in which Congress likely would have intended to defer to the states. *See, e.g.*, *Mayo*, 258 F. Supp. at 1108

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[7] Notably, Labor Code § 450 does not fall within the express state-law savings provisions Plaintiffs cite. *See Bloemendaal* Br. at 21 nn.10-11. Those provisions apply only to the regulatory and enforcement activities of state securities commissions and equivalent entities. *See* 15 U.S.C. §§ 77p(e), 78bb(a), 78bb(f)(4).

(declining to apply presumption against preemption in litigation involving the use of California arbitration standards in the securities context "[b]ecause of the well-established federal presence in the fields of arbitration and securities regulation").

Regardless, even applying the presumption to this case changes nothing. The presumption is just a tie-breaker when the points on either side of the debate are in equipoise. Presumption or not, "one can assume that Congress or an agency ordinarily would not intend to permit a significant conflict" between state and federal law. *Geier*, 529 U.S. at 885. To be sure, courts do "not lightly decide" preemption questions. *Chae*, 593 F.3d at 944. But even state laws that involve "matter[s] of special concern to the states" must give way to conflicting federal enactments. *Fidelity Fed. Sav. & Loan Ass'n v. Cuesta*, 458 U.S. 141, 153 (1982); *see also id*. ("'The relative importance to the State of its own law is not material when there is a conflict with a valid federal law, for the Framers of our Constitution provided that the federal law must prevail.'" (quoting *Free v. Bland*, 369 U.S. 663, 666 (1962))). In all cases, courts have a "duty to consider carefully what Congress was trying to accomplish … and whether [the plaintiffs'] state law claims create an 'obstacle' to the congressional purposes." *Chae*, 593 F.3d at 944. Where there is clear evidence of a conflict between state and federal law, this Court has not hesitated to hold the state law unenforceable, notwithstanding the presumption against preemption. *See, e.g.*, *id*. at 944-48 (holding that Department

of Education regulations and policies governing student loans preempted the application of California's Unfair Competition Law).

As the preceding sections reveal, the state-federal conflict in this case is not even a close question, either as to impossibility or obstacle preemption. So the Court does not need the presumption to tip the scales.

II. PLAINTIFFS HAVE WAIVED THEIR NONDELEGATION ARGUMENT, WHICH IS, IN ANY EVENT, MERITLESS.

For the first time on appeal, and only in the most cursory fashion, the *Bloemendaal* Plaintiffs raise a completely different challenge to the SRO rules at issue in this case—an assertion of improper delegation. This Court should decline even to consider the argument as waived. *See, e.g.*, *Travelers Prop. Cas. Co. v. ConocoPhillips Co.*, 546 F.3d 1142, 1146 (9th Cir. 2008) ("As we have often stated, we will not review an issue raised for the first time on appeal, unless necessary to prevent manifest injustice.").

Regardless, Plaintiffs' argument is meritless. The argument is based on stale cases from a century ago that pre-date the development of modern nondelegation principles. *See Bloemendaal* Br. at 38 (citing cases from 1886, 1912, and 1928). Plaintiffs' resort to those cases is ironic to say the least. Back in that pre-New Deal era—the so-called "*Lochner* Era"—the Supreme Court was so active in striking employee protections that Labor Code § 450 itself likely would have been

invalidated. The law has evolved as much since then on principles of delegation as it has on *Lochner*-type activism.

To the extent Plaintiffs contend that Congress made an excessive delegation when it enacted ITSFEA, their assertion stands at odds with an unbroken line of Supreme Court authority stretching back some 75 years repeatedly approving expansive delegations. *See, e.g.*, *Mistretta v. United States*, 488 U.S. 361, 372-73 (1989) ("[T]his Court has deemed it 'constitutionally sufficient if Congress clearly delineates the general policy, the public agency which is to apply it, and this boundaries of the delegated authority.'" (quoting *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 105 (1946))). Even "broad general directives" that merely instruct an administrator to set prices that "'in his judgment will be generally fair and equitable'" or to adopt regulations that accord with the "'public interest'" have been held valid on the ground that they set forth an "intelligible principle" to which the administrator must conform. *Mistretta*, 488 U.S. at 372, 378 (quoting *Yakus v. United States*, 321 U.S. 414, 420 (1944); *Nat'l Broad. Co. v. United States*, 319 U.S. 190 (1943)). There can be no question under these precedents that Congress set forth an intelligible principle when it directed the SEC to "adopt rules or regulations to require specific policies or procedures reasonably designed to present misuse in violation of this chapter … of material, nonpublic information." 15 U.S.C. § 78o(g).

Moreover, Plaintiffs' criticism that the SEC has improperly "re-delegated its rule-making authority from Congress to an SRO," *Bloemendaal* Br. at 38, is unsupported by any citation to case-law or other authority and rests on a basic misunderstanding of the structure of the federal securities regulatory system. The SEC has not "re-delegated" anything. Rather, Congress itself has established the symbiotic relationship between the SEC and the SROs. The Exchange Act, as amended, expressly authorizes SROs to submit proposed rules to the SEC, describes the approval process, and requires the SEC to approve SRO rules that it finds "consistent with the requirements of [the Exchange Act] and the rules and regulations issued under [it]." 15 U.S.C. § 78s(b)(2)(C)(i); *see also Credit Suisse*, 400 F.3d at 1128 (explaining that "[t]he Securities Exchange Act of 1934 created a system of supervised self-regulation in the securities industry whereby organizations such as the NASD and NYSE could promulgate their own governing rules and regulations, subject to oversight by the [SEC]"). This is not an instance in which an agency, on its own, has attempted to shift its regulatory responsibility to some new and unforeseen entity.

Finally, Plaintiffs are simply wrong to suggest that the SROs have somehow improperly re-re-delegated rulemaking authority "to firms such as Defendant, *i.e.*, private self-interested parties." *Bloemendaal* Br. at 38. The SRO rules at issue in this case entail no delegation of governmental authority to broker-dealers. The

rules simply describe what firms must do to comply with Congress's directive to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse … of material, nonpublic information." 15 U.S.C. § 78o(g). The SROs and the SEC determine whether broker-dealers have acted in conformity with the requirements of the Exchange Act and its implementing rules and regulations. And while the rules require broker-dealers to supervise their employees, they do not confer on broker-dealers any public regulatory authority over those employees. It remains the province of the SROs and SECs, not broker-dealers, to determine the legality of employee conduct.

CONCLUSION

For the foregoing reasons, this Court should affirm the district court's orders rejecting Plaintiffs' compelled patronage claims.

Respectfully submitted,

Dated: January 20, 2012 ORRICK, HERRINGTON & SUTCLIFFE LLP

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STATEMENT OF RELATED CASES

Pursuant to Circuit Rule 28-2.6, the *Hanson* and *Bloemendaal* cases are related to two other cases pending in this Court: (1) *Heilemann v. Bank of America Corp.*, No. 11-55943, and (2) *McDaniel v. Wells Fargo Invs., LLC*, No. 11-17017. All of these cases address whether federal securities law preempts California Labor Code § 450 as applied to the personal trading accounts of brokerage firm employees. In light of that significant substantive overlap, the parties filed a joint motion seeking to have the cases heard together. This court granted the parties' request and ordered the cases consolidated for briefing and oral argument before a single panel. *See* Order in 11-55958, *Bloemendaal v. Morgan Stanley Smith Barney*, ECF. No. 11 (Nov. 21, 2011).

CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32 (a)(7)(C) and Ninth Circuit Rule 32-1, I certify that the attached answering brief is proportionately spaced, has a typeface of 14 points or more, and contains 14,654 words.

Dated: January 20, 2012 ORRICK, HERRINGTON & SUTCLIFFE LLP

/s/ E. Joshua Rosenkranz
E. Joshua Rosenkranz
Attorneys for Defendant-Appellee

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on January 20, 2012.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

/s/ Trish M. Higgins
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