

# Financial Services ADR: What the United States Could Learn From South Africa

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## Introduction

In *Shearson/American Express v. McMahon*,<sup>1</sup> the U.S. Supreme Court held that pre-dispute arbitration agreements are enforceable for securities disputes. Since that decision in 1987, the dominant method for resolving investment-related disputes between clients and broker-dealers or their representatives in the U.S. has been through arbitration conducted by the Financial Industry Regulatory Authority (FINRA).<sup>2</sup> FINRA handles more than 99% of securities-related mediations and arbitrations in the U.S.<sup>3</sup> However, despite the importance of FINRA arbitration in the U.S., few pieces have been written comparing the U.S. system with financial services alternative dispute resolution (ADR) systems available in other countries and evaluating the quality of the FINRA system.<sup>4</sup>

The problem is finding a point of comparison. That is, which country has been successful in regulating its financial markets while using a regime that is similar enough to the American model to make a useful comparison? One country that stands out as a great candidate for such a comparison is South Africa. According to the Global Economic Competitiveness Report, South Africa is ranked third in the world for its overall financial market development and is among the ten best in the world in terms of legal rights in its financial markets.<sup>5</sup> In addition to its success, the South African financial regime also shares much in common with the regulatory structure in the U.S., having both a national financial services regulator and a special ADR system for dealing with disputes between clients and

1. 482 U.S. 220 (1987).

2. See FIN. INDUS. REG. AUTH., FINRA DISPUTE RESOLUTION: ARBITRATION, MEDIATION AND THE NEUTRALS WHO SERVE 1 (2011) [hereinafter FINRA DISPUTE RESOLUTION], available at <http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@fdr/documents/arbmed/p124105.pdf>.

3. See *id.*

4. See, e.g., Shahla F. Ali & Antonio Da Roza, *Alternative Dispute Resolution Design in Financial Markets—Some More Equal Than Others: Hong Kong's Proposed Financial Dispute Resolution Center in the Context of the Experience in the United Kingdom, United States, Australia, and Singapore*, 21 PAC. RIM L. & POL'Y J. 485 (2012) (comparing Hong Kong's proposed system with the U.S.'s); Cory Alpert, *Financial Services in the United States and United Kingdom: Comparative Approaches to Securities Regulation and Dispute Resolution*, 5 BYU INT'L L. & MGMT. REV. 75 (2008) (comparing the U.S. system to the United Kingdom's); *Ombudsman: An Attractive Alternative to FINRA Mediation?*, FLA. INT'L UNIV. INVESTOR CLINIC (Dec. 15, 2011), <http://fiuinvestorclinic.wordpress.com/2011/12/15/ombudsman-an-attractive-alternative-to-finra-mediation/> (comparing FINRA ADR to the Canadian system).

5. See WORLD ECON. FORUM, GLOBAL COMPETITIVENESS REPORT 2012-2013 at 324-25 (Klaus Schwab ed., 2012).

financial services providers.<sup>6</sup>

In the U.S., most disputes between clients and broker-dealers or their representatives are resolved in arbitration through FINRA.<sup>7</sup> In South Africa, the Financial Advisory and Intermediary Services Ombud (FAIS Ombud) runs the ADR system.<sup>8</sup> In both systems, a customer who files a qualifying complaint has the right to have her case resolved under the alternative system rather than through traditional litigation, and the result of the alternative system is binding.<sup>9</sup> The parties benefit because ADR is more efficient and less costly than traditional litigation.<sup>10</sup> The court system benefits since cases that would otherwise be litigated are resolved in ADR,<sup>11</sup> which decreases docket congestion. However, despite high-level similarities between the broader regimes, there are important differences between the FAIS Ombud and FINRA arbitrations. The purpose of this Note is to explore the financial services ombudsman system in South Africa and compare it to FINRA's securities arbitration system in the United States, highlighting the differences between the two and identifying potential areas of improvement in the U.S. system.

#### A. Evaluation Criteria

In evaluating FINRA arbitration and the FAIS Ombud, this Note uses four criteria to compare the two systems: (1) efficiency, (2) accessibility, (3) procedural fairness, and (4) substantive rules. The efficiency criterion looks at whether a particular feature of the South African or U.S. ADR system tends to promote a quick disposition of a matter. The accessibility criterion looks at how easily a client with a financial services dispute can gain access to the ADR venue. The procedural fairness criterion looks at whether there is a risk of either party being abused as a result of a particular procedural mechanism or lack thereof. The substantive rules criterion looks at whether there are substantial differences between the substantive rights afforded to clients in the U.S. and South African ADR systems. In particular, this Note considers a client's right of action for unsuitability,

6. See *infra* text accompanying notes 19–24.

7. See FINRA DISPUTE RESOLUTION, *supra* note 2, at 1; David S. Ruder, *Foreword to NAT'L ASS'N OF SEC. DEALERS, THE ARBITRATION POLICY TASKFORCE REPORT—A REPORT CARD 1* (2007).

8. See Daleen Millard, *Bespoke Justice? On Financial Ombudsmen, Rules and Principals*, 44 DE JURE 232, 236–37 (2011). It's worth noting that FINRA also has an ombudsman. However, the role of the FINRA Ombudsman is very different from the FAIS Ombud. See *Office of the Ombudsman*, FINRA, <http://www.finra.org/AboutFINRA/Ombudsman/> (last updated Sept. 16, 2013).

9. In the U.S., arbitration awards can be entered as a judgment in court. See FIN. INDUS. REG. AUTH., *FINRA Code of Arbitration Procedure* [hereinafter *Code of Procedure*] for *Customer Disputes* R. 12904, in FINRA MANUAL (2013) [hereinafter *FINRA MANUAL*], available at [http://finra.complinet.com/en/display/display\\_viewall.html?rbid=2403&element\\_id=1&record\\_id=1](http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=1&record_id=1). In South Africa, the FAIS Ombud's determination has the same effect as a judgment in a civil court. See Financial Advisory and Intermediary Services Act 37 of 2002 § 28(5) (S. Afr.) [hereinafter *FAIS Act*].

10. See JAY E. GRENIG, *ALTERNATIVE DISPUTE RESOLUTION* § 1:2 (3d ed. 2013) (listing the benefits of ADR).

11. *C.f. id.* § 6:21.

unauthorized trading, misrepresentation, and negligent rendering of a financial service as well as the remedies available to claimants.

## B. Findings

After applying these four criteria, this Note finds that, despite different methods of promulgating rules, the substantive rights given to claimants in both systems are generally similar. However, the FINRA system holds brokers to a slightly lower standard regarding misrepresentations, and its arbitration panels are more limited in their ability to provide injunctive relief.<sup>12</sup> Further, several features of the FAIS Ombud system encourage more efficient and procedurally fair outcomes.<sup>13</sup> In particular, the FAIS Ombud's adjudicator qualifications, pre-filing requirement, summary disposition mechanism, and appeals process all suggest possible improvements to the FINRA system.

## C. Overview

This Note begins in Part I by looking at the institutional backgrounds of the two ADR systems, including the broader regulatory regimes in South Africa and the United States. Part II analyzes and compares the jurisdiction of FINRA and the FAIS Ombud. Part III compares some of the substantive rights of clients under each system. Part IV looks at the procedural aspects of the FAIS Ombud and FINRA arbitration. Lastly, Part V reviews the comparisons made in Parts I through IV and, based on the beneficial features of the FAIS Ombud system, suggests changes to the FINRA system.

# I. Institutional Background

## A. South Africa

In South Africa, Financial Services Providers (FSPs) are defined by the Financial Advisory and Intermediary Services (FAIS) Act as “any person, other than a representative, who as a regular feature of the business of such person . . . furnishes [financial] advice; or . . . renders an intermediary service.”<sup>14</sup> An intermediary service, in turn, includes facilitating the buy-

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12. See *infra* notes 128-132 and accompanying text; *infra* notes 140-143 and accompanying text.

13. It's important to note that this evaluation only concerns the quality of the features of the system, not the actual results. This Note is not intended to be an empirical exercise. Rather, it focuses on comparing whether the features of each system will *tend to* lead to greater efficiency, accessibility, and procedurally fair outcomes. The actual results would be the subject of future studies.

14. See FAIS Act, *supra* note 9, § 1. Person, for the purposes of the Act, means any natural person, partnership, trust, or corporation. *Id.* Representatives are defined as “any person . . . who renders a financial service to a client for or on behalf of a financial services provider,” except for those who render clerical, technical or administrative services that do not require judgment. See *id.* Thus, in one possible arrangement (and probably the typical one), the FSP would be a financial services company, and its representative would be an employee who is actually working with the client.

ing or selling of financial products.<sup>15</sup> By law, FSPs and their representatives must adhere to the General Code of Conduct for Authorized Financial Services Providers and Representatives (FAIS Code),<sup>16</sup> which sets out their duties when providing financial services.<sup>17</sup> Also, FSPs—but not their representatives—must be licensed with the Financial Services Board.<sup>18</sup>

The Financial Services Board Act of 1990 created the Financial Services Board (FSB), which is responsible for regulating FSPs and their representatives.<sup>19</sup> The FSB is governed by eleven members,<sup>20</sup> all of whom are appointed by the South African Minister of Finance<sup>21</sup> and may be removed by the minister, when “in [his or her] opinion[,] . . . sufficient reasons exist therefor.”<sup>22</sup> The authority of the FSB is broad and, in addition to regulating FSPs, includes the supervision of friendly societies, retirement funds, insurance companies and collective investment schemes.<sup>23</sup>

Beneath the FSB falls the Office of the Ombud for Financial Services Providers, which was created by the FAIS Act of 2002.<sup>24</sup> The head of the Office is the FAIS Ombud, whose job is to resolve disputes between clients and FSPs or their representatives.<sup>25</sup> The Ombud is appointed by the FSB and must be a person who is “qualified in law and who possesses adequate knowledge of the rendering of financial services.”<sup>26</sup> FAIS Act states the objective of the Ombud:

The objective of the Ombud is to consider and dispose of complaints in a procedurally fair, informal, economical and expeditious manner and by reference to what is equitable in all the circumstances, with due regard to (a) the contractual arrangement or other legal relationship between the complainant and any other party to the complaint; and (b) the provisions of [the

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15. *Id.* (“any act . . . performed by a person for or on behalf of a client . . . the result of which is that a client may enter into . . . any transaction in respect of a financial product with a product supplier; or with a view to buying, selling or otherwise dealing in (whether on a discretionary or non-discretionary basis), managing, administering, keeping in safe custody, maintaining or servicing a financial product purchased by a client from a product supplier . . .”).

16. *See id.* § 13(2)(b).

17. *See* General Code of Conduct for Authorized Financial Services Providers and Representatives [hereinafter FAIS Code], 25299 Gov. Gazette at 20 (Aug. 8, 2003) (S. Afr.), available at <http://www.info.gov.za/view/DownloadFileAction?id=64687>.

18. FAIS Act, *supra* note 9, § 7(1). However, there is an important group of professionals who are exempt from this and every other requirement of the FAIS Act. The Act does not apply to persons who are authorized under the Financial Markets Act of 2012 to provide securities services, including brokers who are registered with a stock exchange. *See id.* § 45(1). This will be important in Part II that compares the jurisdictions of the two systems.

19. *See* Financial Services Board Act 97 of 1990 § 2 (S. Afr.).

20. *See Board Members*, FINANCIAL SERVICES BOARD, <https://www.fsb.co.za/aboutUs/Pages/board.aspx> (last visited Oct. 10, 2013).

21. Financial Services Board Act 97 of 1990 § 4(1) (S. Afr.).

22. *Id.* § 6(2).

23. *See id.* § 3 (“The functions of the board are to supervise and enforce compliance with laws regulating financial institutions and the provision of financial services”); *id.* § 1 (defining “financial institution” and “financial service”).

24. *See* FAIS Act, *supra* note 9, § 20.

25. *See id.* §§ 20–24.

26. *Id.* § 21(1)(a).

FAIS Act].<sup>27</sup>

The Ombud carries out this objective by hearing complaints from clients, conducting an investigation, and rendering a binding decision.<sup>28</sup> Unlike a court, the Ombud has more simplified procedures and conducts its hearings in a less formal manner.<sup>29</sup> The substantive rules that the Ombud applies are primarily embodied in the FAIS Code, which is drafted and published by the registrar of financial service providers,<sup>30</sup> who is also the executive officer of the Financial Service Board.<sup>31</sup> However, the Ombud may also apply other substantive rules including those from the FAIS Act or the common law.<sup>32</sup>

## B. The United States

In the U.S., any person or company in the business of brokering or dealing<sup>33</sup> securities must be registered with the Securities and Exchange Commission (SEC).<sup>34</sup> The SEC, which is a rough analogue to the FSB, was founded as part of the Securities Exchange Act of 1934 and is in charge of enforcing federal securities laws in the U.S.<sup>35</sup> The SEC regulates a variety of securities-related actors, including issuers, underwriters, broker-dealers, mutual funds, and investment advisors.<sup>36</sup> The SEC is empowered to make

27. *Id.* § 20(3).

28. *See generally infra* notes 155–216 and accompanying text (describing how the Ombud hears and resolves disputes).

29. *See* FAIS Act, *supra* note 9, § 20(3).

30. *Id.* § 15.

31. *Id.* § 2.

32. *See id.* § 40.

33. A broker is defined as “any person engaged in the business of effecting transactions in securities for the account of others,” 15 U.S.C. § 78c(4) (2012), while a dealer is defined as “any person engaged in the business of buying and selling securities . . . for such person’s own account through a broker or otherwise.” *Id.* § 78c(5). While the Exchange Act defines the two terms differently, most rules do not distinguish between the two. Robert L.D. Colby & Lanny A. Schwartz, *What Is a Broker-Dealer*, in *BROKER-DEALER REGULATION 2-4* n.1 (Clifford E. Kirsch ed., 2d. ed. 2012). “Broker-dealer” will be used for the remainder of this Note unless there’s a need to distinguish between the two.

34. *See* 15 U.S.C. § 78o(a)(1). An “associated person of a broker or dealer,” such as a brokerage firm’s representative, is not required to register. *See* §§ 78c(18), o(a)(1). However, representatives generally must register with a self-regulatory organization, like FINRA. *See* NASD R. 1031, in *FINRA MANUAL*, *supra* note 9.

35. *See* 15 U.S.C. § 78d(a). Some of the laws that the SEC is in charge of enforcing include the Securities Act of 1933 (dealing with issuing of securities), the Securities Exchange Act of 1934 (dealing with the exchange of securities), the Trust Indenture Act of 1939 (dealing with debt financings of public companies), the Investment Company Act of 1940 (dealing with the regulation of mutual funds), and the Investment Advisers Act of 1940 (dealing with the registration and regulation of investment advisors). THOMAS LEE HAZEN, *FEDERAL SECURITIES LAW 1* (3rd ed. 2011). In addition to the SEC, different state agencies and statutes also regulate the securities industry. State laws that relate to the issuance, sale or trading of securities are referred to as “blue sky” laws. *Id.* at 24. The jurisdiction of state securities commissions in charge of enforcing “blue sky” laws, however, has been substantially diminished by the National Securities Markets Improvement Act, which preempts a significant portion of state securities regulations. *Id.*

36. *See id.* at 1–2.

binding rules to regulate the securities industry, so long as the rules are carried out in accordance with the authorizing statutes.<sup>37</sup>

While the SEC has the authority to regulate broker-dealers, self-regulatory organizations (SROs) like FINRA oversee a large portion of the securities industry.<sup>38</sup> SROs are non-governmental organizations that regulate the financial services industry through rules and procedures that the SEC reviews and approves.<sup>39</sup> Broker-dealers, in addition to registering with the SEC, must be a member of an SRO,<sup>40</sup> typically FINRA.<sup>41</sup> Representatives of broker-dealers must also register with FINRA.<sup>42</sup>

The FINRA board of governors, which is the highest body within FINRA, is in charge of approving the rules that FINRA promulgates.<sup>43</sup> FINRA's board of governors consists of the CEO of FINRA and a mix of public and industry governors who are elected by FINRA's member firms.<sup>44</sup> None of the governors are appointed by a government official.<sup>45</sup> Among the twenty-two current governors on the FINRA board, ten are industry governors,<sup>46</sup> meaning they represent the interests and expertise of the financial services industry.<sup>47</sup>

In addition to its regulatory function, FINRA also provides arbitration

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37. *Id.* at 5.

38. *Id.* at 5, 154. FINRA is the product of the merger of the National Association of Securities Dealers (NASD) and the New York Stock Exchange's regulatory arm in 2007. Today, FINRA handles the former self-regulatory functions of the NASD and the New York Stock Exchange. *See id.* at 154.

39. SROs like FINRA have been empowered to regulate this way through the Maloney Act. *See* 15 U.S.C. § 78o-3. However, all SROs must register with the SEC and be subject to the SEC's oversight. *See id.* For an overview of the rulemaking process, *see* Fin. Indus. Reg. Auth., *FINRA Rulemaking Process*, FINRA, <http://www.finra.org/%20Industry/Regulation/FINRARules/RulemakingProcess/> (last accessed Oct. 12, 2013) [hereinafter *FINRA Rulemaking Process*].

40. *See* 15 U.S.C. § 78o(b)(8) ("It shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is a member of a [registered] securities association."). FINRA is a registered securities association.

41. BROKER-DEALER & INV. MGMT. REG. GRP., PROSKAUER ROSE LLP, BROKER-DEALER REGISTRATION AND FINRA MEMBERSHIP APPLICATION 2 (2011), available at <http://www.proskauer.com/files/uploads/broker-dealer/Broker-Dealer-Registration-FINRA-Membership-App.pdf>.

42. *See* Fin. Indus. Reg. Auth., *Selecting Investment Professionals*, FINRA, <http://www.finra.org/Investors/SmartInvesting/GettingStarted/SelectingInvestmentProfessional/P117278> (last visited Oct. 12, 2013).

43. *See* *FINRA Rulemaking Process*, *supra* note 39.

44. *See* Fin. Indus. Reg. Auth., *FINRA Board of Governors*, FINRA, <http://www.finra.org/AboutFINRA/Leadership/P009756> (last updated Aug. 6, 2013) [hereinafter *FINRA Board of Governors*]; *By-Laws of the Corporation Art. III sec. 4*, in *FINRA MANUAL*, *supra* note 9.

45. *See* *By-Laws of the Corporation Art. III sec. 4*, in *FINRA MANUAL*, *supra* note 9.

46. *See* *FINRA Board of Governors*, *supra* note 44.

47. For example, Gregory Fleming, who sits on the FINRA board, is the current Executive Vice President, President of Asset Management, and President of the Global Wealth Management group at Morgan Stanley. Morgan Stanley, Annual Report (Form 10-K) 21 (2011), available at <http://www.sec.gov/Archives/edgar/data/895421/000119312511050049/d10k.htm>.

services through its arbitration arm<sup>48</sup>—FINRA Dispute Resolution—which is a subsidiary of FINRA.<sup>49</sup> FINRA Dispute Resolution’s primary purpose is to help resolve securities-related disputes between clients and broker-dealers or their representatives.<sup>50</sup> FINRA arbitration is less formal than traditional litigation and uses simplified procedures.<sup>51</sup> Through a strike and rank system, parties select a panel of one or three neutral arbitrators, who make the final arbitration decision.<sup>52</sup>

All arbitrators on a panel are categorized as either public or non-public. Non-public arbitrators must have some background in the securities industry, while public arbitrators only need five years of business or professional experience and at least two years of college-level credits.<sup>53</sup> None of the panelists except for the chairperson needs to have a legal background.<sup>54</sup> FINRA generates a random list of arbitrators through its Neutral List Selection System,<sup>55</sup> and each party has the opportunity to strike a number of arbitrators from the list and rank the remaining in the order of their preference.<sup>56</sup> From these rankings, the arbitration panel is chosen.

### C. Comparison

The financial services regulatory regimes of South Africa and the U.S. are similar in that both regimes contain an ADR avenue for disputes

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48. By contrast, the SEC cannot adjudicate disputes between private parties. See HAZEN, *supra* note 35, at 4. However, even without FINRA, private parties would always have the option of bringing an action under the federal securities laws in state or federal court.

49. FIN. INDUS. REG. AUTH., REGULATORY NOTICE 10-32: DISPUTE RESOLUTION BY-LAWS (2010), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121697.pdf>.

50. See *id.* at 1. In addition to arbitration between clients and broker-dealers, FINRA also handles employment disputes between broker-dealers and their representatives and business disputes between broker-dealer firms. See *Code of Procedure for Industry Disputes* R. 13200, in FINRA MANUAL, *supra* note 9.

51. For example, FINRA has a simplified discovery process in which both parties are given a list of documents that are presumptively discoverable. See *Code of Procedure for Customer Disputes* R. 12506, in FINRA MANUAL, *supra* note 9 (“Document Production Lists 1 and 2 describe the documents that are presumed to be discoverable in all arbitrations between a customer and a member or associated person.”); see also FIN. INDUS. REG. AUTH., DISCOVERY GUIDE 3 (2011) [hereinafter DISCOVERY GUIDE], available at <http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p123494.pdf>.

52. See *Code of Procedure for Customer Disputes* R. 12400(a), in FINRA MANUAL, *supra* note 9.

53. FIN. INDUS. REG. AUTH., *FINRA’s Arbitrators*, FINRA (Jan. 19, 2013), <http://www.finra.org/ArbitrationAndMediation/Arbitrators/BecomeanArbitrator/FINRAArbitrators/index.htm> [hereinafter *FINRA’s Arbitrators*].

54. See *Code of Procedure for Customer Disputes* R. 12400, in FINRA MANUAL, *supra* note 9. In fact, in some cases, the chairperson does not need to have a law degree if he or she has previously served as an arbitrator on three arbitrations administered by an SRO. *Id.*

55. *Id.*

56. See *Code of Procedure for Customer Disputes* R. 12402, 12403, in FINRA MANUAL, *supra* note 9.



between clients and financial advisors.<sup>57</sup> However, the American and South African regimes differ in a number of important ways. The first is that FINRA, an SRO, runs the securities ADR system in the U.S. One of the underlying reasons for the SRO model is that the cost of financial services regulation is largely borne by the industry itself, rather than taxpayers.<sup>58</sup> In addition, the SRO model promises a better balance between beneficial regulation and market efficiency because the rule makers are also members of the financial services industry.<sup>59</sup> Financial services professionals, who are free from political influence and experienced in the industry, are thought to be in the best position to know which rules will be effective and which will be overly burdensome.<sup>60</sup>

The FAIS Ombud system takes a very different approach. The rule maker in South Africa—the Registrar of Financial Services providers—enjoys relatively little autonomy from the political landscape because he was appointed and can be removed by the Minister of Finance.<sup>61</sup> Further, the Financial Services Board Act explicitly discourages appointing a Registrar who is actually engaged in the financial services industry. The Act sets up a presumption of ineligibility for industry members that can only be overcome by the Minister conducting his due diligence with the relevant association or organization that such industry member is engaged in.<sup>62</sup>

But does this mean that the U.S. model will tend to produce better substantive rules? Not necessarily. As a preliminary matter, FINRA rule makers are not completely autonomous. They must have all their rule proposals approved by the SEC.<sup>63</sup> Further, even if they were completely free from government interference, the SRO system doesn't come without risks. While the SRO system promises a better balance between regulation and efficiency, allowing the industry to regulate itself can lead to setting a lower standard for financial services professionals.<sup>64</sup>

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57. By “financial advisor,” the author means broker-dealers and their representatives in the U.S., and FSPs and their representatives in South Africa.

58. Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C.L. REV. 475 (1984).

59. *Id.*

60. *Cf. id.*

61. See Financial Services Board Act 97 of 1990 §§ 4, 6 (S. Afr.).

62. *Id.* § 5 (“No person shall be appointed as a member or an alternate member of the board . . . if, in the opinion of the Minister, he or she is actually engaged in the business of a financial institution or actually engaged in the rendering of a financial service: Provided that the Minister may, in consultation with the recognised association or organisation of the relevant financial institution or financial service in which such person is actually engaged, appoint a person who would otherwise be disqualified in terms of this paragraph from being a member of the board”). Since the Registrar is a member of the FSB, this standard applies to him.

63. See *FINRA Rulemaking Process*, *supra* note 39.

64. See Smythe, *supra* note 58, at 476. Whether the SRO model is beneficial overall is outside the scope of this Note, but for a great discussion on the matter, see generally *Panel Discussion: Crisis in Confidence-Self-Regulation in the Securities Industry*, 10 *FORDHAM J. CORP. & FIN. L.* 167, 175-201 (2005).

In any case, it appears that the difference between the government and SRO rulemaking bodies has not—at least yet—translated into any serious differences between the substantive rules that the U.S. and South Africa have chosen to govern broker-dealers and FSPs, respectively. As we will see in Part III, the substantive rights of clients regarding suitability, unauthorized trading, and negligence are very similar in both systems.<sup>65</sup> And while there is a difference between the systems' rules on misrepresentation, the difference is only significant in a limited range of circumstances.<sup>66</sup> Thus, in the financial services ADR context, it is not clear whether the U.S. or South African model will tend to produce better substantive rules.

Another difference is the selection and qualification of adjudicators. In South Africa, the FSB appoints the Ombud, who must be someone “qualified in law and who possesses adequate knowledge of the rendering of financial services.”<sup>67</sup> Once appointed, the Ombud is the sole adjudicator for cases brought before her and may only be removed by the FSB for good cause.<sup>68</sup> In this way, the Ombud serves a role closer to that of a traditional judge than an arbitrator. Under the FINRA system, a different panel of arbitrators is chosen for each dispute through the strike and rank system,<sup>69</sup> and only the chairperson of the panel must be an attorney.<sup>70</sup> Arbitrators are not required to have any understanding of the law, and their failure to have such an understanding is generally not grounds for overturning an arbitrator's decision.<sup>71</sup> Moreover, public arbitrators are not even required to have experience in the securities industry.<sup>72</sup>

The advantage of the South African system is that adjudicators are less likely to be under qualified or uninformed.<sup>73</sup> Contrary to FINRA arbitrators, the Ombud is required to have a legal background and benefits from

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65. See *infra* notes 144-153 and accompanying text.

66. See *id.*

67. FAIS Act, *supra* note 9, § 21(a). The FSB can also appoint one or more deputy ombuds. For an interesting article on Noluntu Bam, a current Deputy Ombud, see Bruce Cameron, *Bam Gives You a Fair Deal*, PERSONAL FINANCE (July 20, 2012, 8:40 PM), <http://www.iol.co.za/business/personal-finance/financial-planning/financial/bam-gives-you-a-fair-deal-1.1343455#.UKv3pmeraSo>.

68. FAIS Act, *supra* note 9, § 21(4).

69. See *Code of Procedure for Customer Disputes* R. 12400(a), in FINRA MANUAL, *supra* note 9.

70. See *Code of Procedure for Customer Disputes* R. 12400(c), in FINRA MANUAL, *supra* note 9.

71. See *Wallace v. Buttar*, 378 F.3d 182, 190 (2d Cir. 2004) (noting that “a court reviewing an arbitral award cannot presume that the arbitrator is capable of understanding and applying legal principles with the sophistication of a highly skilled attorney. Indeed, this is so far from being the case that an arbitrator ‘under the test of manifest disregard is ordinarily assumed to be a blank slate unless educated in the law by the parties.’”).

72. See FINRA's *Arbitrators*, *supra* note 53.

73. For clarity, this is not to say that FINRA arbitrators, as an empirical matter, are underqualified in any respect or are less qualified than the Ombud. Rather, this Note argues that because the *minimum* qualification requirements for FINRA arbitrators, particularly public arbitrators, are lower than those of the Ombud regarding their legal and securities experience, there is a greater risk of FINRA arbitrators making an uninformed decision.

hearing many (if not most) of the financial services disputes that are heard through her office. The Ombud will thus likely be in a better position to render decisions that are in-line with the current state of the law.

One drawback is that the Ombud is less likely to be neutral and independent as compared to a FINRA arbitrator. This is true for two reasons. First, because the FSB is authorized to appoint and remove the Ombud,<sup>74</sup> there is a possibility that the agenda of the FSB and the Minister will influence the Ombud's decisions. Second, unlike in the FINRA system, the Ombud lacks a negative feedback mechanism that promotes neutrality.<sup>75</sup> In the FINRA system, the selection process encourages neutrality among arbitrators by allowing parties to strike arbitrators that they view as biased.<sup>76</sup> Thus, if an arbitrator has a long history of always (or never) granting awards in favor of the claimant, they are likely to be struck by the respondents (or claimants).<sup>77</sup> The Ombud has no such feedback mechanism from the parties. Therefore, in terms of adjudicator selection, the South African system provides fewer procedural safeguards for the parties than the FINRA system.

## II. Jurisdiction

### A. South Africa

The jurisdiction of the FAIS Ombud is broad. Indeed, the cases brought before the FAIS Ombud involve everything from stocks<sup>78</sup> to real estate syndication,<sup>79</sup> and even car insurance.<sup>80</sup> According to the statute, the FAIS Ombud may hear all complaints that

relat[e] to a financial service rendered by a financial services provider or representative to the complainant . . . in which . . . the provider or representative - (a) has contravened or failed to comply with a provision of [the FAIS] Act and that as a result thereof the complainant has suffered or is likely to suffer financial prejudice or damage; (b) has wilfully or negligently rendered a financial service to the complainant which has caused prejudice or damage to the complainant or which is likely to result in such prejudice or damage; or (c) has treated the complainant unfairly.<sup>81</sup>

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74. See FAIS Act, *supra* note 9, § 21. The FSB members are, in turn, appointed by the Minister of Finance. See Financial Services Board Act 97 of 1990 § 4 (S. Afr.).

75. See *Code of Procedure for Customer Disputes* R. 12403, in FINRA MANUAL, *supra* note 9.

76. See *Code of Procedure for Customer Disputes* R. 12400(a), in FINRA MANUAL, *supra* note 9.

77. See *Code of Procedure for Customer Disputes* R. 12406, in FINRA MANUAL, *supra* note 9 (“[A]ny party may ask an arbitrator to recuse himself or herself from the panel for good cause.”); see also *Code of Procedure for Customer Disputes* R. 12407, in FINRA MANUAL, *supra* note 9 (allowing a director to remove an arbitrator).

78. See e.g., Meyer v. Van Der Merwe, FOC 4566/06-07/UN1 (March 31, 2010) (S. Afr.), available at [http://www.faisombud.co.za/library/meyer\\_04566.pdf](http://www.faisombud.co.za/library/meyer_04566.pdf).

79. See, e.g., Kapp v. Wanadoo, FAIS 05639/10-11/WC1 (April 11, 2012) (S. Afr.), available at [http://www.faisombud.co.za/library/kapp\\_05369.pdf](http://www.faisombud.co.za/library/kapp_05369.pdf).

80. See e.g., Mojela v. Estene Brokers, FAIS 00150/08-09/GP/3 (May 14, 2012) (S. Afr.).

81. See FAIS Act, *supra* note 9, § 1.

Within this broad mandate, the FAIS Ombud generally has the authority to hear any financial services claim arising from a violation of the FAIS Act, the FAIS Code or any common law duty that pre-existed the FAIS Act,<sup>82</sup> so long as the claim does not fall within the jurisdiction of another Ombud.<sup>83</sup>

However, there are some restrictions on the jurisdiction of the FAIS Ombud. Most importantly, the Ombud cannot hear any complaint against a securities broker who is an authorised user of a licensed stock exchange—which would include, for example, all the brokers on the Johannesburg Stock Exchange—if the complaint relates to a securities transaction.<sup>84</sup> Further, the Ombud may not hear complaints on behalf of the general public; complainants must be individuals or a group of individuals.<sup>85</sup> Lastly, the Ombud may not investigate any complaints which constitute a monetary claim in excess of 800,000 South African rand (just over \$73,000), unless the responding party has agreed to exceed this limit in writing.<sup>86</sup>

## B. United States

In the U.S., courts strongly favor arbitration, and the jurisdiction of arbitration panels is accordingly broad. Arbitration panels are granted authority through the Federal Arbitration Act.<sup>87</sup> Under the Act, any “written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable . . . .”<sup>88</sup> The Supreme Court has held that arbitration agreements

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82. This is because FAIS Act does not change or supersede the common law. *See id.* § 40; Millard, *supra* note 8, at 237.

83. Since the creation of the FAIS Ombud, the South African parliament has enacted legislation that establishes a council to consider, grant, or refuse other financial services ombud schemes. Financial Services Ombud Schemes Act 37 of 2004 §§ 2, 8 (S. Afr.). However, the jurisdiction of new ombuds is limited to specific areas and participants within the financial services realm. *See id.* § 13. Where jurisdiction is unclear as between two competing financial services ombuds, the FAIS Ombud has exclusive jurisdiction. *See id.* § 13(3)(b).

84. FAIS Act, *supra* note 9, § 45(1) (“The provisions of this Act do not apply to the rendering of financial services by any ‘authorised user’ . . . as defined in section 1 of the Financial Markets Act, 2012 that is authorised by that Act to render those financial services.”); Financial Markets Act 19 of 2012 § 1 (S. Afr.) (defining “authorised user” as someone who is authorized by a licensed exchange and involved in the business of buying or selling securities or rendering advice in connection with the purchase or sale of securities).

85. *See* FAIS Act, *supra* note 9, § 1 (defining “complainant” as “a specific client who submits a complaint to the ombud.”); *About FAIS Ombud*, FAIS OMBUD, <http://www.faisombud.co.za/about> (“‘Client’ means a specific person or group of persons, excluding the general public . . . .”) (last visited Oct. 12, 2013).

86. Rules on Proceedings of the Office of the Ombud for Financial Services Providers Notice 81 of 2003 § 4(c) (S. Afr.) [hereinafter FAIS Rules on Proceedings].

87. 9 U.S.C. §§ 1-2 (2012).

88. *Id.* § 1.

involving securities disputes are equally binding.<sup>89</sup>

The arbitration agreement signed by the parties establishes the scope of an arbitration panel's jurisdiction,<sup>90</sup> which can include federal and state securities law claims as well as claims based on FINRA rules and common law fiduciary duties.<sup>91</sup> If there is a conflict between a state's blue sky laws and the Federal Arbitration Act—for example where state law would not allow the state cause of action to go to arbitration—the Arbitration Act will prevail, and the state claims will go to arbitration instead of court.<sup>92</sup>

Even if parties agree to arbitrate in the FINRA forum, the type of dispute that can be heard must be in accordance with FINRA rules. Under FINRA rules, parties must arbitrate where: (1) the dispute “arose in connection with the business activities of the [FINRA] member or associated person;” (2) it involves a client and a FINRA member; and (3) either FINRA arbitration is required by a written agreement or is requested by the client.<sup>93</sup> Thus, it is not necessary that the parties agreed to submit to arbitration before the dispute arose. A client can force a FINRA member or its representative into arbitration without the member having ever agreed to arbitrate.<sup>94</sup> Failure to submit to a client's request to arbitrate where the FINRA rules require it constitutes a violation of FINRA's code of arbitration, which could result in disciplinary action against the member.<sup>95</sup>

In addition to FINRA's jurisdiction over client complaints, it also has jurisdiction over disputes between industry members.<sup>96</sup> Under FINRA rules, an intra-industry dispute generally must be arbitrated if it relates to the business activities of a member or associated person and is between or among members, members and associates, or associates.<sup>97</sup> This would include a dispute between broker-dealer firms, or between a broker-dealer and its employee.

However, there are limitations on cases that a FINRA arbitration panel may hear. This is because FINRA limits the scope of claims that it allows

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89. See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (holding that pre-dispute arbitration agreements are enforceable for securities disputes, despite the limitation imposed by federal securities statutes).

90. See *Sigma v. Dean Witter Reynolds, Inc.*, 766 F.2d 698, 704 (2d. Cir. 1985) (“An arbitration panel derives its jurisdiction from an agreement of the parties.”).

91. See THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* § 15.1[1]-[4] (West 2013).

92. *Id.*

93. *Code of Procedure for Customer Disputes* R. 12200, in *FINRA MANUAL*, *supra* note 9. Parties may but are not required to arbitrate a dispute if the first two requirements are met and both parties subsequently agree in writing to submit the dispute to the arbitration panel. *Code of Procedure for Customer Disputes* R. 12201, in *FINRA MANUAL*, *supra* note 9.

94. See *id.*

95. See *Code of Procedure for Customer Disputes* R. 12000, in *FINRA MANUAL*, *supra* note 9.

96. See *Code of Procedure for Industry Dispute* R. 13200, in *FINRA MANUAL*, *supra* note 9.

97. *Id.* However, arbitration between industry members is not mandatory in disputes involving sexual harassment, discrimination or whistleblower statutes. *Code of Procedure for Industry Dispute* R. 13201, in *FINRA MANUAL*, *supra* note 9.

panels to entertain. Most importantly, FINRA panels can only hear claims involving a FINRA member.<sup>98</sup> Also, even where all the requirements for permissive arbitration are met, parties may not arbitrate a dispute if the dispute involves the insurance business activities of a member that is also an insurance company.<sup>99</sup> Lastly, FINRA panels cannot hear shareholder derivative suits or class actions.<sup>100</sup>

### C. Comparison

The jurisdictions of both the FAIS Ombud and FINRA arbitration panels are both relatively broad. However, they differ significantly in the types of financial services claims they can hear. In South Africa, the Ombud cannot hear claims involving securities transactions by authorized users of licensed exchanges<sup>101</sup> while, in the U.S., FINRA can only hear claims against FINRA members.<sup>102</sup> This means that the accessibility of each ADR system is largely dependent on the *type* of financial service provided. For example, an investment advisor in the U.S. can render advice relating to the purchase of securities and would not be subject to FINRA arbitration, so long as he or she does not actually broker the sale and thus is not a FINRA member.<sup>103</sup> Rendering that same advice in South Africa would give the Ombud jurisdiction. Conversely, if someone in the U.S. brokers the sale of securities, she must be a FINRA member and, in turn, subject to FINRA's jurisdiction. The same is not true with respect to the Ombud's jurisdiction, if the broker is an authorized user of a licensed exchange. This difference can be further complicated where insurance is thrown into the mix. In the U.S., a salesperson can broker the sale of an insurance product or render advice in connection with that sale while avoiding FINRA's membership and jurisdiction.<sup>104</sup> These same financial services would fall within the Ombud's purview in South Africa.

What does all of this mean in terms of the accessibility criterion? While there are some circumstances in which the two systems overlap,<sup>105</sup> each system gives greater access to the venue depending on the financial service. The Ombud provides greater access for clients with insurance disputes because, regardless who sold the product, the Ombud can hear the complaint. FINRA, on the other hand, provides greater access for clients

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98. See *Code of Procedure for Customer Disputes* R. 12201, in FINRA MANUAL, *supra* note 9.

99. *Id.*

100. HAZEN, *supra* note 91, at § 15.1[11].

101. See *supra* note 84 and accompanying text.

102. See *Code of Procedure for Customer Disputes* R. 12201, in FINRA MANUAL, *supra* note 9.

103. See Suzanne Barlyn, *COMPLY-FINRA Reignites Efforts to Oversee Investment Advisers*, REUTERS (Nov. 21, 2012), <http://www.reuters.com/article/2012/11/21/finra-advisers-comply-idUSL1E8MK60H20121121>. However, investment advisors must register with the SEC. See 15 U.S.C. 82b-3 (2012).

104. This is because insurance products are not necessarily considered "securities" under federal law. See HAZEN, *supra* note 35, at 26. Thus, insurance brokers are not required to be FINRA members.

105. One example would be a broker involved in the sale of unlisted securities.

with securities disputes because, whether the securities are listed or not, whoever brokered the transaction must have been a FINRA member.

Another difference is the source of their jurisdictions. While the Ombud derives its jurisdiction directly from the FAIS Act, FINRA jurisdiction is established through a combination of the Federal Arbitration Act and the arbitration agreement.<sup>106</sup> Because of the additional requirement of an arbitration agreement, it might appear that FINRA arbitration is a less accessible venue than the FAIS Ombud. However, for two reasons, this likely is not the case. First, broker-dealers in the U.S. almost uniformly require their clients to sign an arbitration agreement before opening an account.<sup>107</sup> Second, even if a client does not have an arbitration agreement, FINRA rules require members to submit to arbitration if the requirements of permissive arbitration are met and the client wants to arbitrate.<sup>108</sup> Thus, it is unlikely that a client desiring the FINRA venue will be denied for lack of an arbitration agreement.

However, the claimant cannot have it both ways. The Federal Arbitration Act makes pre-dispute arbitration agreements enforceable against all parties.<sup>109</sup> This means a client who wants to resort to the courts after signing an arbitration agreement will not be able to do so without the blessing of the respondent. South Africa, on the contrary, would allow the client to. Because almost all brokers require clients to sign an arbitration agreement before opening an account,<sup>110</sup> clients in the U.S. are largely denied access to the courts.

But does mandatory arbitration mean that the FINRA system is less procedurally fair than the FAIS Ombud system? It does not. Under the South African system, a respondent is denied access to courts if the claimant chooses FAIS Ombud as the venue<sup>111</sup>—and without the respondent consenting to it beforehand. Because procedural fairness is a two-way street, the claimant's inability to litigate in the U.S. must be weighed against the respondent's inability to do so in South Africa. Therefore, if procedural fairness is determined considering both parties' rights, the outcome is a wash.

Even putting the cross-country comparison aside, there are a number of good arguments for why the U.S. system is not procedurally unfair to claimants. First, the procedures available in arbitration might be more claimant-friendly than in litigation.<sup>112</sup> If so, denying the claimant access to the courts would not be a detriment at all. Second, whether or not arbi-

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106. See *supra* notes 87-90 and accompanying text.

107. See Ruder, *supra* note 7, at 1.

108. Code of Procedure for Customer Disputes R. 12200, in FINRA MANUAL, *supra* note 9.

109. See 9 U.S.C. § 1-2.

110. See Ruder, *supra* note 7, at 1.

111. See Risk v. Ombud for Fin. Serv. Providers 2012, no. 38791/2011, 1 (HC) at 11 para. 38 (S. Afr.) (declining respondent's access to court in lieu of ongoing proceeding before the Ombud).

112. For a discussion of the benefits of arbitration for the claimant, see Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 PACE L. REV. 1174, 1187-91 (2010).

tration clauses are the industry norm, the client still consented to the procedure and was on notice before the initial transaction. Third, a client's inability to escape a binding arbitration clause may be fair because, as discussed above, it balances the client's ability to force their broker into arbitration without an arbitration agreement. Lastly, as will be discussed in Part III, claimants have a number of substantive rights in FINRA arbitration that they *do not have* in a federal or state court,<sup>113</sup> so claimants may benefit from entering arbitration over litigation.

Considering the foregoing, it is unclear that forced arbitration makes the FINRA system less procedurally fair than South Africa's Ombud system. What is clear, however, is that forced arbitration means that the soundness of the procedural mechanisms available in FINRA arbitration—discussed in Part IV—are especially important because the claimant has no alternative.

The final difference is each system's jurisdiction to hear intra-industry disputes among those in the financial services industry. While the FAIS Act does not specifically mention industry disputes, its language also does not preclude an FSP from being a complainant, so long as they are a "client."<sup>114</sup> According to the text, then, the FAIS Ombud has jurisdiction to resolve disputes between FSPs. However, despite the ability to hear such disputes, there are two limitations on the FAIS Ombud's jurisdiction when compared to FINRA. First, because complainants must be clients, the FAIS Ombud is unable to hear complaints from employees of FSPs.<sup>115</sup> More importantly, assuming that disputes between FSPs involve larger sums, the 800,000 Rand limitation is likely a barrier for FSPs wanting to use the FAIS Ombud to resolve disputes.<sup>116</sup> Therefore, this barrier limits access to the Ombud forum where the FINRA system does not.

### III. Substantive Duties and Rights

In South Africa and the U.S., the substantive duties of FSPs and broker-dealers—and the corresponding rights of clients—in the financial services ADR systems come from a variety of sources. In South Africa, these

113. See *infra* at notes 148-150 and accompanying text.

114. FAIS Act, *supra* note 9, § 1 (defining client as "a specific person or group of persons, excluding the general public, who is or may become the subject to whom a financial service is rendered intentionally"). Furthermore, there is no requirement that a claimant be a natural person. See *id.* See, e.g., *Dolphins Creek Golf Estate v. Gericke*, FOC 2246/07-08/WC 1 (May 14, 2012) (S. Afr.), available at [http://www.faisombud.co.za/library/dolphins\\_creek\\_golf\\_estate\\_02246.pdf](http://www.faisombud.co.za/library/dolphins_creek_golf_estate_02246.pdf).

115. Unless, of course, an employee is also a client of the FSP.

116. Indeed, the dollar figures in FINRA arbitration often far exceed 800,000 rand. See, e.g., Nate Raymond, *Judge Blocks Auction Rate Arbitration Against Citigroup*, CHI. TRIB. (May 6, 2013), [http://articles.chicagotribune.com/2013-05-06/business/sns-rt-us-citigroup-arbitrationbre9450rb-20130506\\_1\\_auction-rate-arbitration-finra-financial-industry-regulatory-authority](http://articles.chicagotribune.com/2013-05-06/business/sns-rt-us-citigroup-arbitrationbre9450rb-20130506_1_auction-rate-arbitration-finra-financial-industry-regulatory-authority) ("Increasingly large awards began spilling out of FINRA as a result of the economic meltdown that began in 2008 . . . . The largest during that period was a \$406.6 million award STMicroelectronics NV won in February 2009 in a case against a unit of Credit Suisse Group AG over auction-rate securities. By April 2012, the number of arbitrations pending with more than \$10 million at stake had hit around 200 . . . .").



rights come from three primary sources: the FAIS Act, the FAIS Code, and the common law.<sup>117</sup> In the U.S., they come primarily from the Exchange Act, the FINRA Code of Arbitration, and the common law. In both jurisdictions, if a financial advisor violates a client's right given by common law, statute, or the code of conduct, the violation is actionable in the ADR system.<sup>118</sup> In the U.S., however, the violation of a FINRA Rule is generally not actionable in court.<sup>119</sup>

### A. Suitability

In South Africa, an FSP or its representative must take reasonable steps to gather information about a client's financial situation when rendering advice.<sup>120</sup> After this, the FSP is required to conduct an analysis using the information and identify the products that will be appropriate for the client's risk appetite and financial needs.<sup>121</sup> However, an FSP or representative's obligation does not stop there. If the client chooses to enter into a different transaction than the one recommended, the FSP or its representative is still required to alert the client to the clear existence of any risk and to advise the client to "take particular care to consider whether any product selected is appropriate to the client's needs."<sup>122</sup>

In the United States, the analogue to the FAIS Code's suitability rule is FINRA Rule 2111(a), which requires the following:

A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.<sup>123</sup>

Under the FINRA rule, a client's investment profile includes the client's age, other investments, financial situation, tax status, risk tolerance and liquidity needs.<sup>124</sup> While the FINRA rule is a slightly longer and more specific, it demands approximately the same duty of FINRA members and

117. The FAIS Act and the FAIS Code are the primary sources of clients' rights. However, they are not the exclusive sources, because the FAIS Act does not change, but rather adds to clients' rights under the common law. See FAIS Act, *supra* note 9, § 40 ("No provision of this act . . . may be construed as affecting any right of a client . . . to seek appropriate legal redress in terms of the common law or any other statutory law.").

118. See FAIS Act, *supra* note 9, § 20(3); *Code of Procedure for Customer Disputes* R. 12201, in FINRA MANUAL, *supra* note 9.

119. See HAZEN, *supra* note 35, at 153 ("the overwhelming majority of cases have denied the existence of a private remedy by an injured investor based solely on the violation of an applicable rule of a self-regulatory organization."). See e.g., *In re VeriFone Sec. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993) ("It is well established that violation of an exchange rule will not support a private claim.").

120. See FAIS Code, *supra* note 17, § 8(1)(a).

121. *Id.* § 8(1)(b-c). See e.g., *Ramdass v. Standard Bank Fin. Consultancy*, FOC 882/05/KZN/(1), at 18 (Oct. 20, 2005) (S. Afr.) (applying suitability analysis to FSP who sold an illiquid asset to a client who needed funds to purchase a property).

122. FAIS Code, *supra* note 17, § 8(4)(b).

123. *Duties and Conflicts* R. 2111(a), in FINRA MANUAL, *supra* note 9.

124. *Id.*

their representatives: they must sufficiently understand the needs of the client when recommending investments.

### B. Unauthorized Trading

In South Africa, when purchasing or selling a financial product on behalf of a client, an FSP must do so “in accordance with the contractual relationship and reasonable requests or instructions of the client, which must be executed as soon as reasonably possible . . . .”<sup>125</sup> Unless the FSP has been given explicit authorization to exercise discretion in selling or purchasing products—something known as a discretionary account—the FSP must have authorization for each particular trade; failure to do so would be a violation of the FAIS Code and actionable before the Ombud.<sup>126</sup> FINRA Rules similarly state that “[n]o member or registered representative shall exercise any discretionary power in a customer’s account unless such customer has given prior written authorization to a stated individual or individuals . . . .”<sup>127</sup> Thus, both ADR systems provide similar rules against unauthorized trading and require explicit authorization for discretionary accounts.

### C. Misrepresentation

In South Africa, an FSP is under a specific duty to ensure that all information provided to a client is factually correct when rendering a financial service.<sup>128</sup> Further, any information also must be provided in plain language that avoids uncertainty and confusion, and it must not be misleading.<sup>129</sup> However, in order for the misrepresentation to establish liability, the misrepresentation must have caused the financial prejudice suffered by the client, and it must be material in that the investor relied on it in making his or her decision.<sup>130</sup> This approach means that, even if an FSP or its representative was reasonably diligent—not negligent—in presenting information to a client, liability will be incurred if the client relies on the information and, as a result, incurs a loss.

In contrast to the requirements of the FAIS Code, the FINRA rule on misrepresentations sets a slightly lower bar for FSPs. FINRA Rule 2020

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125. FAIS Code, *supra* note 17, § 3(1)(d).

126. See *Ludewig v. Van Der Merwe*, FOC 661/05/GP/(1), at 8 (March 20, 2007) (S. Afr.), available at [http://www.faisombud.co.za/library/ludewig\\_00661.pdf](http://www.faisombud.co.za/library/ludewig_00661.pdf) (“[P]roviders are required to obtain authorisation in order to render financial services in respect of particular financial products. It is against the FAIS Act for providers to render financial services in respect of a product for which the provider is not authorised, even if the provider believes that he has the necessary skill and expertise in respect of the product.”).

127. *Business Conduct R. 2510*, in FINRA MANUAL, *supra* note 9.

128. FAIS Code, *supra* note 17, § 3(1)(a)(i) (“When a provider renders a financial service representations made and information provided to a client by the provider must be factually correct.”). See e.g., *Ludewig*, FOC 661/05/GP/(1), at 8.

129. *Id.* § 3(1)(a)(ii).

130. See *Ramdass*, FOC 882/05/KZN/(1), at 16 (“[T]here must be a nexus between the false statement and the resultant contract in order to allow redress on the basis of the misrepresentation.”).

states, “[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.”<sup>131</sup> FINRA has found this rule to be violated only where the broker presented information in at least a reckless fashion.<sup>132</sup> However, the rule does not mandate that all the information provided to the client be true or that it be plainly intelligible. So long as the broker-dealer or its representative does not act recklessly in providing information in connection with a transaction, he or she cannot be held liable under FINRA Rule 2020.

#### D. Negligent Rendering of a Financial Service

In South Africa, an FSP’s duty of care is rooted in both the FAIS Code and the common law. Under the FAIS Code, the FSP is held to a general duty of care and loyalty: “[a] provider must at all times render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry.”<sup>133</sup> In addition to this statutory duty, an FSP also has duties under the common law such that an FSP’s willful or negligent failure to act with reasonable care and skill and in good faith is actionable, if such failure leads to financial damages.<sup>134</sup> If it is shown that an FSP acted in a negligent manner or in a manner inconsistent with the FAIS Act or the FAIS Code, it is not a defense to say that the client allowed him to do so. An FSP cannot request or induce a client to waive any right or benefit conferred on the client by the FAIS Code, and cannot rightly accept or act on any such waiver; any such waiver is null and void.<sup>135</sup>

In the United States, there is no FINRA rule explicitly addressing negligence. However, negligent behavior constitutes a breach of FINRA Rule 2010.<sup>136</sup> Also, broker-dealers and their representatives are subject to state-based common law duties to exercise due care in connection with the cli-

131. *Duties and Conflicts R. 2020*, in FINRA MANUAL, *supra* note 9.

132. See *Dep’t of Enforcement v. Manaia*, No. 2009018818101 (FINRA Discip. Proc. June 28, 2013), available at <http://www.finra.org/web/groups/industry/documents/ohodecisions/p325357.pdf> (holding that NASD Rule 2120 was not violated by negligent conduct); *Dep’t of Enforcement v. Golub*, No. C10990024, 2000 NASD Discip. LEXIS 14 at \*8 (Nov. 17, 2000) (“[W]e find that [the respondent] acted at a minimum recklessly in making the misrepresentations, and we affirm the Hearing Panel’s finding that he violated . . . [NASD] Conduct Rule 2120.”). NASD Rule 2120 has since been converted to FINRA Rule 2020. See *Fin. Indus. Reg. Auth., Rule Conversion Charts*, FINRA, <http://www.finra.org/Industry/Regulation/FINRARules/p085560> (last updated Dec. 13, 2012).

133. FAIS Code, *supra* note 17, § 2.

134. See *Millard*, *supra* note 8, at 237.

135. FAIS Code, *supra* note 17, § 21.

136. See *Duties and Conflicts R. 2010*, in FINRA MANUAL, *supra* note 9 (“A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”); *Manaia*, No. 2009018818101, at 5 (“In this case, the evidence establishes that . . . [the broker] . . . acted negligently and violated the standard of care imposed upon him by NASD Rule 2110 and FINRA Rule 2010.”).

ent's account.<sup>137</sup> Breach of that duty constitutes negligence, which is actionable before a FINRA arbitration panel if damages result.<sup>138</sup> Finally, like in South Africa, broker-dealers and their representatives cannot contract with clients to avoid compliance with federal and SRO rules.<sup>139</sup>

#### E. Remedies Available

In South Africa, the FAIS Ombud is empowered to make any award or order that a court could make, including damages or an injunction.<sup>140</sup> FINRA arbitration panels, on the other hand, are more limited in their ability to order injunctions. While FINRA rules allow for the granting of a permanent injunction in the case of a dispute between industry members,<sup>141</sup> they do not allow so for the granting of a temporary injunction.<sup>142</sup> Moreover, injunctive relief is not available at all in customer disputes.<sup>143</sup>

#### F. Comparison of Substantive Rights

On the whole, a client's substantive rights with respect to suitability, unauthorized trading and negligence are similar under both the U.S. and South African systems. However, there is a difference regarding the rules of misrepresentation. In the U.S., a broker-dealer or representative would only violate the FINRA rule when he or she acted recklessly in conveying

137. See Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 736.

138. See HAZEN, *supra* note 91, § 15.1[4] (“[S]tate common law claims remained subject to arbitration agreements under the Federal Arbitration Act.”). Indeed, in 2012, 1941 cases in FINRA arbitration involved a negligence claim. Fin. Indus. Reg. Auth., *Dispute Resolution Statistics*, FINRA, <http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/> (last updated Sept. 16, 2013).

139. 15 U.S.C. § 78cc(a) (“Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.”).

140. See FAIS Act, *supra* note 9, § 28(1) (stating that a final determination by the Ombud may include “a direction . . . that the authorised financial services provider, representative or other party concerned take such steps in relation to the complaint as the Ombud deems appropriate and just.”).

141. See *Code of Procedure for Industry Disputes* R. 13804, in FINRA MANUAL, *supra* note 9. The jurisdiction where the events took place or a choice of law agreement signed by the parties governs the legal standard for whether a permanent injunction will be granted. *Code of Procedure for Industry Disputes* R. 13804(b)(4), in FINRA MANUAL, *supra* note 9.

142. However, in intra-industry disputes that the code requires to be submitted to arbitration, “parties may seek a temporary injunctive order from a court of competent jurisdiction.” *Id.* Once a court grants the temporary injunction, the FINRA panel holds an expedited hearing on the merits. See NAT’L ASS’N SEC. DEALER, NOTICE TO MEMBERS 02-13: INJUNCTIVE RELIEF 78 (Feb. 2002) [hereinafter NASD Notice to Members 02-13], available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003765.pdf>.

143. The arbitration code for customer disputes does not mention injunctive relief. However, FINRA has indicated that injunctions are only available in industry disputes. See NASD Notice to Members 02-13, *supra* note 142 (“[T]emporary injunctive relief is not available in arbitration. Parties in intra-industry cases may seek temporary injunctive relief in a court of competent jurisdiction.”).

the materially false or misleading information.<sup>144</sup> In South Africa, a strict liability standard is imposed on FSPs and representatives when conveying information.<sup>145</sup>

Because the FINRA rule on misrepresentation does not establish liability short of reckless action, it would appear that the U.S. rule provides less protection for clients. However, once negligence is taken into account, clients still are relatively well-protected. For example, while a broker-dealer who negligently conveyed unconfirmed information to a client in connection with a transaction would not violate FINRA Rule 2020—because he or she did not act with the adequate level of culpability—the broker-dealer would still be liable for negligence and a violation of Rule 2010.<sup>146</sup> Under the FINRA system, the only instance where a client could be injured without remedy against the broker-dealer would be where the broker-dealer acted diligently—non-negligently—to check for accuracy, but the information was still incorrect and caused a loss for the client. Thus, while South Africa definitely holds FSPs to a higher standard regarding misrepresentation, it is unclear whether the Ombud system offers a “better” substantive rule.

Another difference is the range of claims that are actionable *only* in each of the ADR systems. In South Africa, the substantive rights of parties in front of the FAIS Ombud are no different than those of a party in a court of law.<sup>147</sup> Thus, regardless of the root of the substantive right—the FAIS Act, the FAIS Code or the common law—the client has the option of bringing the action to the Ombud or to court.<sup>148</sup> In the U.S., on the other hand, certain claims like the violation of a FINRA rule are generally only actionable before a FINRA arbitration panel and not before a court of law.<sup>149</sup> For example, if a client filed a complaint against its broker-dealer in a federal court, alleging a violation of a FINRA rule as the sole basis of liability, the court would likely grant a defendant’s motion to dismiss for failure to state a claim because the violation of a FINRA rule is not, in itself, actionable in federal court. This does not mean that the violation of a FINRA rule is not relevant for actions in court. Indeed, violation of a FINRA rule is likely

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144. See *supra* note 132 and accompanying text.

145. See FAIS Code, *supra* note 17, § 3(1)(a)(i) (“When a provider renders a financial service representations made and information provided to a client by the provider *must* be factually correct.”) (emphasis added). Note that the language of the rule does not require any level of culpability for a violation. *Id.*

146. See *Manaia*, No. 2009018818101 (dismissing alleged violation of FINRA Rule 2020 but holding that respondent’s negligent conduct violated FINRA Rule 2010). If a broker-dealer or its representative was diligent, she also would not be liable under section 12(2) of the Securities Act or section 10(b)—and Rule 10b-5—of the Exchange Act. See 15 U.S.C. §§ 77f, 78j; 17 C.F.R. § 240.10b-5; Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847, 850-52 (1991).

147. See *Millard*, *supra* note 8, at 237 (“Any conduct that falls short of the standards set out by [the FAIS Act and the FAIS Code] is actionable by a client who had suffered damage or prejudice.”).

148. See *id.* However, a client cannot bring an action to the Ombud and to court simultaneously. See FAIS Act, *supra* note 9, § 27(3)(b)(i).

149. See *HAZEN*, *supra* note 35, at 153.

strong evidence of negligence or other improper behavior.<sup>150</sup> However, violation of a FINRA rule is not a valid cause of action outside of FINRA arbitration.

Does this mean that the South African system provides more substantive rights than the U.S. system? It depends on how you define the scope of the U.S. and South African systems. If the scope is each country's entire investor's rights scheme—including the rights actionable in courts—then the South African system provides more rights to investors. However, the purpose of this Note is to compare the *ADR systems*, and therefore, the “systems” are limited to FINRA arbitration and the FAIS Ombud. Thus, the fact that a violation of a FINRA rule is not actionable in court does not weigh against the U.S. system for the purposes of the substantive rules criterion.<sup>151</sup>

Regarding remedies, the U.S. and South African systems depart on the availability of injunctions. While the Ombud has the authority to grant injunctive relief to claimants,<sup>152</sup> FINRA omits this option from its customer code and limits it to the granting of permanent injunctions for intra-industry disputes.<sup>153</sup> Although FINRA may have had some reasons for doing so,<sup>154</sup> FINRA's limitations on granting injunctive relief mean that the U.S. financial services ADR system has fewer options for making claimants whole under the substantive rules criterion.

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150. See, e.g., *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969) (“[V]iolations of [an NASD Rule] would be admissible as evidence of negligence . . .”).

151. However, even considering the broader rights of the American investors, there may be a strong policy reason—outside the criteria mentioned—for the U.S. not to allow violations of the FINRA rules to be actionable: courts would be usurping Congress's role as lawmaker by implying a private cause of action for FINRA rules violations. See Amnon Wenger, *See No Evil, Hear No Evil, Don't Get Sued: Should a Private Cause of Action Exist for a Violation of NASD Conduct Rule 3010?*, 74 *FORDHAM L. REV.* 303, 326–28 (2005) (discussing policy reasons why private rights of action should not be implied). FINRA's board of governors, which approves FINRA rules, is only accountable to FINRA members. See *By-Laws of the Corporation Art. III sec. 4*, in *FINRA MANUAL*, *supra* note 9 (describing the composition of the FINRA Board of Governors). While not being accountable to the greater public may be appropriate—and perhaps even good—for the purposes of making rules that are enforced against industry members within the financial services ADR system, it likely is not appropriate in the context of a court of law, which enforces rules created by politically accountable representatives. South Africa does not have the same accountability issue because the FAIS Act was passed by parliament and the FAIS Code was promulgated under the Act. Thus, it is perfectly appropriate for either the Ombud or a court of law to enforce the FAIS Code and the FAIS Act.

152. See FAIS Act, *supra* note 9, § 28(1).

153. See *supra* notes 141–143 and accompanying text.

154. For example, FINRA may have eliminated the availability of temporary injunctions due to the necessary lead time of putting together an arbitration panel. That is, because it takes time to assemble arbitrators through the strike and rank system—in contrast to finding a judge—FINRA may have believed that it was better to leave temporary injunctions to the courts. Also, regarding injunctions in customer disputes, FINRA may have left out the rule because its rule makers believed monetary damages were a sufficient remedy in the customer dispute context.

## IV. Procedural Rights

### A. Pre-filing Requirements

In South Africa, aggrieved clients have the option of either litigation or ADR before the FAIS Ombud. However, before bringing a case before the Ombud, the complainant must first attempt to resolve the dispute with the respondent.<sup>155</sup> Only if the respondent fails to adequately address the complaint within six weeks may a complaint then be submitted to the Ombud.<sup>156</sup> Furthermore, as required by the FAIS Code, FSPs must maintain their own internal dispute resolution procedures for investors.<sup>157</sup> The procedures must be fair and, if the dispute cannot be resolved internally, the institution is required to inform the investors of their rights to external solutions.<sup>158</sup>

In the U.S., there are no pre-filing requirements to resolving disputes before a FINRA arbitration panel. However, if a respondent wants to use the FINRA forum and the claimant first tries to bring the action in court, there is an additional step: the respondent needs to file a motion to compel arbitration.<sup>159</sup> If granted, the judge will either dismiss the case or, more commonly, order an abatement until the completion of the arbitration process.<sup>160</sup> Where a complaint before a court has both claims that are arbitral and claims that are not, the court will generally sever the arbitral claims and stay judicial proceedings on non-arbitrable claims<sup>161</sup> until arbitration is complete.<sup>162</sup>

### B. Pleading

To properly file a complaint, the claimant “must satisfy the Ombud of having endeavored to resolve the complaint with the respondent,” by stating what steps the claimant took to resolve the dispute before resorting to the Ombud.<sup>163</sup> In order for a claim to be sufficient, it must also fall within the ambit of the FAIS Act and within the rules of the Ombud.<sup>164</sup> As discussed in the previous section on jurisdiction,<sup>165</sup> the FAIS Ombud has the authority to hear a broad range of cases, making this an easy requirement to meet.<sup>166</sup> In a quintessential action, the claimant will allege that (1) the FSP acted in a negligent manner or in a manner which violated the FAIS Act

155. See FAIS Rules on Proceedings, *supra* note 86, § 5(b).

156. *Id.* § 4(a).

157. FAIS Code, *supra* note 17, §§ 17-19.

158. *Id.*

159. See Steven D. Urban, *Securities Arbitration of Investor Disputes: A Primer for the Unwary Practitioner*, 59 THE ADVOCATE (TEXAS) 11, 11 (2012).

160. *Id.*

161. The proceedings for the non-arbitrable claims will also generally be stayed. HAZEN, *supra* note 91, § 15.1[6].

162. *Id.* § 15.1[4].

163. FAIS Rules on Proceedings, *supra* note 86, § 5(d).

164. *Id.* § 4(a)(i).

165. See *supra* notes 78-86 and accompanying text.

166. Of course, this assumes that an “authorised user” under the Financial Markets Act did not render the financial service. See *supra* note 84 and the accompanying text.

or the FAIS Code; (2) as a result of the conduct of the FSP, the claimant suffered financial prejudice; and (3) the prejudice can be quantified as a particular amount of damages.<sup>167</sup> Irrespective of the outcome, when accepting a complaint, the Ombud may require the respondent to pay a non-refundable case fee of 1000 Rand.<sup>168</sup>

Upon receiving the complaint, the Ombud has the right to summarily dismiss the complaint where, upon the facts presented by the complaint, “the complaint or relief sought is of the nature that the Ombud can be of no assistance”; the “complaint does not have any reasonable prospect of success”; or the matter has already been resolved by a court or by the FAIS Ombud.<sup>169</sup> The Ombud may also dismiss the complaint if the respondent has made a reasonable settlement offer.<sup>170</sup>

Like the requirements for bringing a complaint before the Ombud, the pleading requirements for FINRA arbitration are loose. Under the FINRA rules, the claimant need only file a statement of claim with the relevant facts and remedy requested.<sup>171</sup> However, unlike the South African system, a case cannot be dismissed for failure to state a claim.<sup>172</sup> A panel of arbitrators cannot act on a motion to dismiss unless either the non-moving party previously released the claim or the moving party was not associated with the account, securities or conduct at issue.<sup>173</sup> Thus, regardless of the merits of the claim, the respondent will be required to continue to defend the case through the point that the claimant presents his or her case in chief during the hearing on the merits.<sup>174</sup> This has the potential to be considerably onerous for the respondent, as the evidentiary hearing can be several months or a year after the complaint is filed.<sup>175</sup>

### C. Statute of Limitations

The complaint must also comply with the time restrictions of the FAIS Act. Under the FAIS Act, the Ombud must decline to investigate any complaint relating to an act or omission that occurred more than three years before the date of receipt, unless the complainant was unaware of the occurrence.<sup>176</sup> If the complainant was unaware, the three-year period begins on the earlier of the date on which the complainant became aware, or the date on which the complainant should have reasonably become

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167. See Millard, *supra* note 8, at 236; see, e.g., *Mojela v. Estene Brokers*, FAIS 00150/08-09/GP/3, at 7 (2012) (S. Afr.) (outlining the requirements for sustaining an action).

168. FAIS Rules on Proceedings, *supra* note 86, § 9(a)-(b).

169. *Id.* § 7.

170. *Id.*

171. *Code of Procedure for Customer Disputes* R. 12302(a), in *FINRA MANUAL*, *supra* note 9.

172. *Code of Procedure for Customer Disputes* R. 12504, in *FINRA MANUAL*, *supra* note 9.

173. *Id.*

174. See *id.*

175. See *Dispute Resolution Statistics*, *supra* note 138 (stating that the average overall turnaround time for FINRA arbitration is over 14 months).

176. FAIS Act, *supra* note 9, § 27(3)(a)(i).



aware.<sup>177</sup> Also, the complainant must file a complaint within six months after receiving the respondent's final response regarding the dispute, or after such response was due.<sup>178</sup>

Under FINRA rules, the claimant has more time to file,<sup>179</sup> as panels are only restricted from hearing claims where more than six years have lapsed since the occurrence of the event giving rise to the claim.<sup>180</sup>

#### D. Representation

In South Africa, the discretion of the Ombud can have a major impact on the level of legal expertise to which a party has access. While the FAIS Act specifies that the Ombud may allow a party to have legal representation,<sup>181</sup> at least one case has held that the Ombud is not required to do so.<sup>182</sup> Parties' rights to representation are much stronger under the U.S. system. Under FINRA rules, parties may represent themselves<sup>183</sup> but always retain the right to obtain an attorney at law in good standing.<sup>184</sup> FINRA will even allow a party to be represented in arbitration by someone who is not an attorney, so long as the representative is not suspended from the practice of law or the securities industry and the applicable state law allows it.<sup>185</sup>

#### F. Discovery

In South Africa, once the investigation begins, discovery procedures are quite flexible, and largely determined by the Ombud. According to the FAIS Act, when investigating or deciding a complaint, the Ombud may "follow and implement any procedure (including mediation) which the Ombud deems appropriate . . ." <sup>186</sup> Accordingly, the rules of procedure for the Ombud are only seven pages long and list as a fundamental principal that "[i]n disposing of a complaint the Ombud acts independently and objectively and takes no instructions from any person regarding the exer-

177. *Id.* § 27(3)(a)(ii).

178. FAIS Rules on Proceedings, *supra* note 86, § 5(c).

179. However, it is important to remember that there might be other state or federal time limitations, depending on the type of claim. See, e.g., 15 U.S.C. § 77m (listing the time limitations for an action under section 12(a)(2) of the Securities Act).

180. *Code of Procedure for Customer Disputes* R. 12206, in FINRA MANUAL, *supra* note 9. However, dismissal of a claim under Rule 12206 does not prohibit a party from pursuing a claim in court. *Id.*

181. FAIS Act, *supra* note 9, § 27(5)(a).

182. *Risk v. Ombud for Financial Services Providers*, no. 38791/2011, 1 (HC) at 12-15 paras. 39-45 (2012) (S. Afr.) (declining to declare section 27(5)(a) of the FAIS Act unconstitutional and stating that "Section 27 is written in a language that clearly demonstrates the intention of the legislature . . . [T]he Ombud 'may' follow any procedure she considers appropriate including allowing representation. [But s]he is not obliged to do so.").

183. *Code of Procedure for Customer Disputes* R. 12208, in FINRA MANUAL, *supra* note 9.

184. *Id.*

185. *Id.*

186. FAIS Act, *supra* note 9, § 27(5)(a).

cise of [his or her] authority.”<sup>187</sup> The rules also state that parties *may* submit any information or documents they think are relevant, but they *must* produce everything requested by the Ombud.<sup>188</sup> However, all information produced is confidential.<sup>189</sup>

U.S. discovery procedures are more concrete. For the purposes of arbitration, FINRA has a list of presumptively discoverable materials, known as the Discovery Guide.<sup>190</sup> The Discovery Guide includes, among other things, any documentation of correspondence and agreements between the parties relating to the dispute as well as any papers indicating the client’s risk tolerance or the broker-dealer’s investment strategy.<sup>191</sup> If a party to the dispute refuses to produce something that has been requested, the other side may file a motion to compel discovery, and the arbitrator will decide the outcome.<sup>192</sup> The Discovery Guide states that parties are not required to produce documents that are privileged.<sup>193</sup> However, unlike documents produced to the Ombud, not all documents produced to the opposing party must be treated as confidential, and the burden of establishing confidentiality is on the party asserting it.<sup>194</sup>

### G. Appeals

Once the merits of a case are decided, the Ombud must give a written decision.<sup>195</sup> If the Ombud gives a party an adverse determination, the party has the right to appeal the determination to the Board of Appeals, which was established by the Financial Services Board Act.<sup>196</sup> To do so, the party must apply to the Ombud in writing within one month for leave to appeal.<sup>197</sup> In deciding whether to grant leave, the Ombud considers the complexity of the matter and the reasonable likelihood that the Board may reach a different conclusion.<sup>198</sup> If leave is denied, then the party may ask for leave from the Board of Appeals directly within one month of the refusal.<sup>199</sup> If the Board of Appeals grants leave and makes a decision, its determination may be enforced as if it were issued in a civil proceeding of a

187. FAIS Rules on Proceedings, *supra* note 86, § 2. Indeed, any action before the Ombud that would constitute contempt of court in traditional litigation, such as refusing an order to produce a document, can be penalized in the same manner as contempt of court. *See id.* § 31(a).

188. *Id.* §§ 5(f), 6(d).

189. *Id.* § 11(b).

190. *Code of Procedure for Customer Disputes* R. 12506, in FINRA MANUAL, *supra* note 9.

191. *See* DISCOVERY GUIDE, *supra* note 51, at 4-5.

192. *Code of Procedure for Customer Disputes* R. 12509, in FINRA MANUAL, *supra* note 9.

193. *See* DISCOVERY GUIDE, *supra* note 51, at 3.

194. *Id.*

195. FAIS Act, *supra* note 9, § 28(4)(a).

196. *Id.* § 39. *See also* Financial Services Board Act 97 of 1990 § 26A (S. Afr.). The Minister of Finance appoints the board members, at least two of whom are experienced attorneys or judges. *Id.*

197. FAIS Rules on Proceedings, *supra* note 86, § 12.

198. FAIS Act, *supra* note 9, § 28(5)(b)(i).

199. FAIS Rules on Proceedings, *supra* note 86, § 12(e).

High Court of South Africa.<sup>200</sup>

Contrary to the South African procedure, there is no appeals process within the FINRA system.<sup>201</sup> Once an award is handed down, the party against whom the award is rendered must pay within thirty days. The only recourse that the party can take is filing a motion to vacate the award in a court of competent jurisdiction.<sup>202</sup> Motions to vacate arbitration awards are not easily granted. The Federal Arbitration Act provides only four grounds for vacating an award:

(1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.<sup>203</sup>

And the Act only provides three grounds for modifying an award:

(a) [w]here there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award[;] (b) [w]here the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted[;] and] (c) [w]here the award is imperfect in matter of form not affecting the merits of the controversy.<sup>204</sup>

While the Supreme Court has stated that these are not the exclusive grounds for reviewing arbitration awards,<sup>205</sup> other standards of review that have been used, such as “manifest disregard for the law,”<sup>206</sup> are still extremely difficult to satisfy.

In addition, FINRA rules compound the difficulty of vacating or modifying awards by allowing arbitrators to give awards without explana-

200. Financial Services Board Act 97 of 1990 § 26B(17) (S. Afr.).

201. See Fin. Indus. Reg. Auth., *Decision & Award*, FINRA, <http://www.finra.org/ArbitrationAndMediation/Arbitration/Process/DecisionAwards/> (last visited Oct. 13, 2013).

202. *Code of Procedure for Customer Disputes* R. 12904, in FINRA MANUAL, *supra* note 9 (“All monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction.”).

203. 9 U.S.C. § 10.

204. 9 U.S.C. § 11.

205. *Hall St. Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S. 576, 590 (2008) (“In holding that §§ 10 and 11 provide exclusive regimes for the review provided by the statute, we do not purport to say that they exclude more searching review based on authority outside the statute as well. The FAA is not the only way into court for parties wanting review of arbitration awards . . . .”).

206. See, e.g., *Schwartz v. Merrill Lynch & Co., Inc.*, 665 F.3d 444, 451 (2d Cir. 2011) (“[W]e have held that the court may set aside an arbitration award if it was rendered in ‘manifest disregard of the law.’”); *Fukaya Trading Co., S.A. v. E. Marine Corp.*, 322 F. Supp. 278, 282 (E.D. La. 1971) (“An arbitration award is subject to review by this Court and will be vacated only if the award was made in manifest disregard of the law.”).

tions.<sup>207</sup> In fact, in order to receive an explained decision, all parties must request it prior to the prehearing document exchange, and they must pay an additional four hundred dollars.<sup>208</sup> A lack of an opinion is detrimental to a party seeking review because, regardless of the standard of review, it is very difficult to convince a judge that the standard has been met when there is no opinion for the judge to work from. Furthermore, because the testimony of arbitrators impeaching their own awards is generally inadmissible,<sup>209</sup> those seeking to vacate an award face an even more difficult task.

#### H. Enforcement and Effects of a Judgment

In South Africa, the final determination of the Ombud has the same effect as that of a civil court.<sup>210</sup> Immediately after a determination is made, a clerk or registrar of the South African court, which would have had jurisdiction over the case, may issue a writ of execution.<sup>211</sup> Two weeks after the determination, a sheriff of that court may execute the award.<sup>212</sup> The award may contain costs and fees, including legal costs,<sup>213</sup> which are determined by the Ombud.<sup>214</sup> The determination must be written.<sup>215</sup> Once the Ombud issues the determination, it is reported on the Internet.<sup>216</sup>

Arbitration awards from FINRA panels are treated in a slightly different fashion. Like the Ombud's determinations, all awards are made public.<sup>217</sup> However, a FINRA arbitration award need only state certain minimal information, not including the underlying rationale for the award.<sup>218</sup> FINRA awards, like other arbitration awards, require the addi-

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207. See *Code of Procedure for Customer Disputes* R. 12904(e), (f), in *FINRA MANUAL*, *supra* note 9.

208. *Code of Procedure for Customer Disputes* R. 12904(g), in *FINRA MANUAL*, *supra* note 9.

209. See, e.g., *Meer Corp. v. Farmella Trading Corp.*, 178 N.Y.S.2d 784, 786 (Sup. Ct. 1958) (“[T]he testimony of an arbitrator is inadmissible to impeach an award he has signed . . . .”); *Fukaya Trading Co.*, 322 F. Supp. at 279 (“The authorities generally hold that the testimony of an arbitrator tending to impeach the award is incompetent and should be rejected.”).

210. See *FAIS Act*, *supra* note 9, § 28(5).

211. See *id.* § 28(6).

212. *Id.*

213. See Millard, *supra* note 8, at 243 n.86.

214. See *FAIS Rules on Proceedings*, *supra* note 86, § 9.

215. *FAIS Act*, *supra* note 9, § 28(4)(a).

216. See Millard, *supra* note 8, at 244; *Determinations*, OFFICE OF THE OMBUD FOR FINANCIAL SERVICES PROVIDERS, <http://www.faisombud.co.za/determinations>.

217. *Code of Procedure for Customer Disputes* R. 12904(h), in *FINRA MANUAL*, *supra* note 9.

218. *Code of Procedure for Customer Disputes* R. 12904(f), in *FINRA MANUAL*, *supra* note 9. The award must contain the names of the parties, their representatives, and the arbitrators; an acknowledgement by the arbitrators that they have each read the pleadings and other materials filed by the parties; a summary of the issues, including the type(s) of any security or product in controversy; the damages and other relief requested and awarded; a statement of any other issues resolved; the allocation of forum fees and any other fees allocable by the panel; the dates on which the claim was filed and the award was rendered; the dates and locations of hearing sessions; and the signatures of

tional step of having a judgment entered by a court in order for the awards to be legally enforceable.<sup>219</sup> But entering a judgment and having it enforced usually is not necessary because failing to pay an arbitration award is a violation of FINRA rules,<sup>220</sup> and FINRA members can face stiff sanctions for such a violation.<sup>221</sup> In the case where the award is entered against a non-FINRA member, having a judgment entered in any court of competent jurisdiction is necessary for the party desiring to enforce the award.<sup>222</sup>

## I. Comparison

Comparing the procedures in the FAIS Ombud and FINRA arbitration systems illuminates a number of significant differences. First, the South African requirement<sup>223</sup> of attempting to resolve a dispute before entering the Ombud system implicates the efficiency and accessibility criteria. While it presents an additional hurdle for potential claimants, limiting efficiency and accessibility in the short run, the requirement encourages the amicable resolution of disputes between clients and FSPs before resorting to costly arbitration. Thus, in the long run, this feature likely encourages the efficient resolution of disputes. Furthermore, because negotiations between the client and FSP are not binding—that is, the client always has the option of going to the Ombud—the client’s accessibility to the forum is only marginally limited.

Second, while the pleading requirements under both systems are relatively loose, the near complete absence of a summary dismissal device<sup>224</sup> in FINRA arbitration is problematic. One of the policies behind the weak-

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the arbitrators. *Code of Procedure for Customer Disputes* R. 12904(e), in FINRA MANUAL, *supra* note 9.

219. However, a judgment can only be entered based on an arbitration award if either (a) the parties agreed to have the award be enforceable in their arbitration agreement, or (b) the rules of arbitration, which the arbitration agreement adopts by reference, say so. 2 THOMAS H. OEHMKE, COMMERCIAL ARBITRATION § 28:81 (West 2013). In the case of FINRA arbitration, the rules which are adopted are those of FINRA, which do allow for a judgment to be entered. *Code of Procedure for Customer Disputes* R. 12904(a), in FINRA MANUAL, *supra* note 9.

220. *Code of Procedure for Customer Disputes* R. 12000, in FINRA MANUAL, *supra* note 9 (“It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2010 for a member or a person associated with a member to . . . fail to honor an award, or comply with a written and executed settlement agreement . . .”).

221. *Investigations and Sanctions* R. 8310, in FINRA MANUAL, *supra* note 9 (listing the following: “(1) censure a member or person associated with a member; (2) impose a fine upon a member or person associated with a member; (3) suspend the membership of a member or suspend the registration of a person associated with a member for a definite period or a period contingent on the performance of a particular act; (4) expel a member, cancel the membership of a member, or revoke or cancel the registration of a person associated with a member; [or] (5) suspend or bar a member or person associated with a member from association with all members”).

222. *Code of Procedure for Customer Disputes* R. 12904(a), in FINRA MANUAL, *supra* note 9.

223. See FAIS Rules on Proceedings, *supra* note 86, § 5(b).

224. See *supra* notes 171–175 and accompanying text.

ened summary dismissal device is keeping the cost of arbitration down by protecting claimants' attorneys from being required to oppose frivolous motions for summary dismissal. While this policy is very much in line with the efficiency criterion, the result of this rule is that respondents are completely unable to protect themselves from frivolous claims. For example, it is possible for a claimant to force a respondent to go through a full hearing by alleging facts that do not constitute any legal basis for relief under federal, state or SRO rules, so long as the claimant can show that the respondent was somehow associated with the account, securities or conduct at issue.<sup>225</sup> This result is both tremendously inefficient as well as procedurally unfair because of the potential for abuse by a claimant looking to extort a brokerage firm or its representative.

Third, the FAIS Ombud and FINRA systems are markedly different in their approaches to the right of legal representation. The Ombud, in addition to his or her already substantial authority, may further disarm the parties by disallowing the use of legal representation.<sup>226</sup> While the goal of this approach may be to expedite the resolution process or to even the playing field between parties—in the case where an FSP is well-represented and a claimant is not—taking away a party's right to legal representation has an enormous cost in terms of procedural fairness. In addition, doing so may have the effect of slowing down the proceeding where an unsophisticated party does not understand the Ombud system.<sup>227</sup>

Fourth, the discovery procedure under the Ombud is different in that it does not rely as heavily on the adversarial roles of the parties as does the American system. Rather, it relies on the discretion and judgment of the Ombud to determine what is relevant. While the parties may submit documents and information, the Ombud has the ultimate authority to request what will be produced.<sup>228</sup> In FINRA arbitration, by contrast, a panel may suggest that a party submit supporting documents or it may grant a party's motion to compel discovery,<sup>229</sup> but the system primarily relies on the parties and the Discovery Guide to decide which materials are relevant.

The potential benefits of the Ombud's discovery method are that the Ombud can pursue factual inquiries neither party had thought to present, and discovery may be quicker because there is no fighting between the parties over document production. However, the drawbacks far outweigh the potential benefits. First, giving the Ombud sole discretion over the proceedings risks missing important issues. For example, the Ombud may fail to request an important document that one of the parties otherwise would

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225. See *supra* notes 171-175 and accompanying text.

226. See *supra* notes 181-182 and accompanying text.

227. See Stephan Landsman, *The Growing Challenge of Pro Se Litigation*, 13 LEWIS & CLARK L. REV. 439, 449 (2009) (“[S]elf-represented claimants slow[] the clearing of court dockets. Pro se litigants today cause delays and increase administrative costs. They are likely to miss or be unprepared for scheduled courtroom sessions, thereby forcing adjournments and rescheduling.”).

228. See FAIS Rules on Proceedings, *supra* note 86, §§ 2, 5-6.

229. See *Code of Procedure for Customer Disputes* R. 12509, in FINRA MANUAL, *supra* note 9.

have requested. Second, the current loose discovery rules could lead to results that neither party desires. For example, the Ombud could order a party to produce sensitive materials that the other party does not want and would not have requested.<sup>230</sup> Lastly, the Ombud system's lack of basic guidance on discovery rules makes discovery unpredictable and potentially arbitrary. By contrast, parties before a FINRA panel at least have the benefit of knowing—through the Discovery Guide—the minimum of what they will be required to produce and can thus prepare in advance. Considering the foregoing, the costs of the Ombud's discovery method in terms of procedural fairness likely outweigh any of its possible benefits.

Lastly, comparing the Ombud and FINRA systems highlights the difficulty of appealing an award under the American system. Given the high levels of deference provided to arbitration awards and the practice of giving unreasoned awards, vacating or modifying an award is extremely difficult. While this practice could be justified on efficiency grounds if both parties chose to arbitrate beforehand, the reality is that, in the securities ADR context, neither broker-dealers nor clients really choose arbitration; rather, it is forced upon them.<sup>231</sup> Thus, both parties in FINRA arbitration are exposed to the risk that an arbitration panel will make a poor decision that is functionally unappealable. This weighs heavily against the U.S. system in terms of its procedural fairness.

## Conclusion

Having compared the FINRA and FAIS Ombud systems in Parts I through IV, this Note finds that there are a number of features of the South African system that may be preferable to those in the United States' system. Table 1 summarizes the differences and identifies which system has the better approach in terms of the criterion listed. The remainder of Part V will highlight the important differences between the South African and American systems and suggest beneficial changes to the FINRA model.

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230. However, because all the materials produced are confidential, this potential drawback may be less problematic. See FAIS Rules on Proceedings, *supra* note 86, § 11(b).

231. Arbitration is forced upon clients through the near universal use of arbitration agreements when they open accounts. See Urban, *supra* note 159, at 11 (“[V]irtually all investor disputes which traditionally would have been resolved by a judge and a jury are subject to mandatory, binding arbitration before FINRA. Why is this? It is because all BDs include a predispute arbitration agreement in their account agreements with their customers that encompasses virtually any dispute that later arises.”). Arbitration is also forced upon broker-dealers and their representatives through FINRA's own rules. See *Code of Procedure for Customer Disputes* R. 12200, in FINRA MANUAL, *supra* note 9.

Difference	Efficiency	Procedural Fairness	Accessibility	Substantive Rules
State vs. SRO System	*	*	*	Unclear
Min Adjudicator Qualifications	*	R.S.A.	*	*
Adjudicator Selection	*	U.S.	*	*
Securities Disputes	*	*	U.S.	*
Insurance Disputes	*	*	R.S.A.	*
Source of Jurisdiction	*	*	Unclear	*
Mandatory Arbitration	*	Unclear	*	*
Intra Industry Disputes	*	*	U.S.	*
Misrepresentation	*	*	*	Unclear
Actionability of ADR Code	*	N/A	*	N/A
Remedies (injunction)	*	*	*	R.S.A.
Pre-Filing Requirement	R.S.A.	*	U.S.	*
Summary Disposition	R.S.A.	R.S.A.	*	*
Representation	*	U.S.	*	*
Discovery	*	U.S.	*	*
Appeals	U.S.	R.S.A.	*	*

Note: The designation of “U.S.” or “R.S.A” means that the U.S. or South African approach, respectively, tends to perform better based on the vertically listed criterion. An asterisk indicates that the difference in the South African and U.S. rules likely has only minor implications with respect to the listed criterion. “Unclear” means that, while the difference between each jurisdiction’s rules or features is significant, it is unclear which system’s feature or rule performs better under the criterion. “N/A” means that the rule or feature in question implicates the listed criterion but is outside the scope of this Note.

#### A. Institutional Comparison: State vs. SRO and Adjudicator Selection

While the ADR systems in the U.S. and South Africa have similar goals—resolving disputes in an efficient and just manner—different types of actors govern the two ADR systems and their rule-making processes. In South Africa, the office of the FAIS Ombud is a state institution with the Ombud appointed by government officials.<sup>232</sup> In the U.S., FINRA is an SRO in the form of a corporation. FINRA members elect a board of governors composed of a mix of public representatives and industry members to govern FINRA.<sup>233</sup> As discussed in Part I, there are competing arguments over the effectiveness of SROs in regulating the financial services industry.<sup>234</sup> However, for the purposes of comparing ADR systems, both FINRA and the South African rule makers have produced—with the slight exception of misrepresentation—similar substantive rules. Thus, it is not clear whether the SRO or state-based model will tend to produce better substantive rules.

Regarding the adjudicators, while the structure of the American system allows for arbitrators who may be less legally sophisticated, it does a better job of promoting neutrality because the panel consists of a mix of public

232. See FAIS Act, *supra* note 9, § 21(1)(a).

233. See *By-Laws of the Corporation Art. III sec. 4*, in FINRA MANUAL, *supra* note 9.

234. See *supra* notes 58–64 and accompanying text.



and industry arbitrators, and parties have the ability to strike arbitrators with biased arbitration records.<sup>235</sup> Thus, while FINRA should retain the strike and rank system, it should also consider increasing the minimum eligibility requirements of FINRA arbitrators to reduce the risk that they will make arbitration decisions on an uninformed basis.

#### B. Jurisdiction: Services Types, Source, Access to Courts, and Intra-Industry Disputes

The disputes that the ADR systems in South Africa and the U.S. can hear are largely dependent on the type of financial service rendered and who rendered it. The FAIS Ombud is excluded from hearing disputes involving securities transactions of authorized users of licensed exchanges, and FINRA is limited to hearing disputes involving a FINRA member. This means that FINRA is relatively more accessible for securities disputes, while the Ombud system is more receptive to financial services claims involving insurance.

The financial services ADR systems in South Africa and the U.S. derive their jurisdiction from different sources. The FAIS Ombud's jurisdiction comes from statute, whereas FINRA's derives from a combination of the Federal Arbitration Act and the arbitration agreement. While the additional requirement of an agreement could theoretically limit access, FINRA rules make certain that every client of a FINRA member can take its case to arbitration. Thus, assuming proper subject matter, claimants who want to enter the ADR realm have comparable access under either system.

The opposite, however, is not true. While claimants in South Africa have the option of ADR or litigation, the widespread use of arbitration clauses in the U.S. has functionally made FINRA arbitration a requirement for claimants. At first glance, this makes the U.S. system look less procedurally fair relative to South Africa. However, after considering the choice-of-venue interests of respondents in South Africa—along with the other considerations in Part II—the comparison becomes more balanced.

Regarding their ability to hear intra-industry disputes, both ADR systems can hear complaints between industry members who are in a client-provider relationship.<sup>236</sup> However, because the FAIS Ombud is capped in the Rand value of the disputes he or she is allowed to hear, it is unlikely that an industry member seeking a substantial sum from an FSP would have access to the Ombud's venue. Applying the second criterion, this means that the cap in the South African system has a negative impact on accessibility with regards to intra-industry disputes.

#### C. Substantive Rights

Comparing some of the most common substantive rights relating to investments—suitability, unauthorized trading, misrepresentation, and

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235. See *Code of Procedure for Customer Disputes* R. 12400(a), in FINRA MANUAL, *supra* note 9.

236. For a discussion of this, see *supra* notes 114–116 and accompanying text.

negligent rendering of a financial service—both the American and South African systems provide roughly the same protection for clients. As discussed in Part III, while the FINRA rule on misrepresentation only protects clients where a broker-dealer or its representative acts recklessly or purposefully,<sup>237</sup> the rule on negligence fills the gap, leaving clients without a right of action only where the broker-dealer acted non-negligently in conveying information. Thus, while the Ombud rule treats financial advisors more harshly, it does not follow that the FINRA rule is necessarily inadequate in protecting clients.

Another important difference is that violation of a FINRA rule is not actionable in U.S. courts, while violations of the FAIS Code are actionable in South African courts.<sup>238</sup> While this difference has an impact on the substantive rights of financial services clients *outside* the ADR system, it does not speak to clients' substantive rights within. Therefore, this difference does not weigh one way or the other in terms of which system has the more preferable feature.

Turning to remedies, FINRA panels cannot grant temporary injunctions and may only grant permanent injunctions in industry disputes.<sup>239</sup> The Ombud, on the other hand, can do both in any type of case, giving claimants a broader range of substantive rights. Thus, FINRA should consider expanding its ability to grant injunctions.<sup>240</sup>

#### D. Procedural Rights

In the area of procedure, there are a number of significant differences between the two systems that present opportunities for improvement for the American system. First, the Ombud requires that parties attempt to resolve the dispute internally before filing a complaint.<sup>241</sup> FINRA should strongly consider adopting a similar feature. While it would require an additional step that might mildly limit access, such a rule would also encourage early settlement and increase overall efficiency without depriving the claimant of the right to arbitration.<sup>242</sup>

Second, the lack of any meaningful procedural tool for summarily dismissing a claim has the potential to force respondents in FINRA arbitration

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237. See *supra* note 132 and accompanying text.

238. See *supra* notes 114-115 and accompanying text.

239. See *supra* notes 141-143 and accompanying text.

240. Of course, whether FINRA actually should is a question of policy. If FINRA does expand panels' ability to grant injunctive relief, it may want to expand the availability of permanent injunctions in customer cases. As discussed previously, the nature of arbitrator selection makes it very difficult to bring a panel together quickly, and temporary injunctions tend to be very time sensitive. Thus, as a practical matter, it might be better for courts to continue to handle temporary injunctions.

241. See FAIS Rules on Proceedings, *supra* note 86, § 5(b).

242. Some financial services firms already have an internal dispute resolution system in place. See, e.g., *Office of the Ombudsman*, ROYAL BANK OF CANADA, <http://www.rbc.com/ombudsman/> (last accessed Oct. 13, 2013). For those firms that do not have a dispute resolution system, simply requiring claimants to discuss the matter with their broker representative or a branch manager could also be beneficial for both parties and would not require any additional costs for the brokerage firm.

to defend meritless claims. Like the Ombud,<sup>243</sup> FINRA should consider adopting a meaningful tool for summary dismissal. Implementing such a device would benefit the FINRA system's efficiency and procedural fairness.

Lastly, the relative difficulty of gaining review of an arbitration award in the U.S. severely limits the procedural rights of parties before a FINRA arbitration panel.<sup>244</sup> While the inability to appeal within FINRA could be justifiable on efficiency grounds if arbitration was optional, the reality is that it is not. Thus, the U.S. should consider implementing a mechanism that allows for increased review of FINRA awards.<sup>245</sup>

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243. FAIS Rules on Proceedings, *supra* note 86, § 7.

244. For a discussion of this, see *supra* notes 195-209 and accompanying text.

245. This could be done through any of the following: (1) creating an internal system of review within FINRA; (2) giving parties greater access to traditional litigation; (3) softening the standard of review for FINRA arbitration awards; or (4) requiring FINRA arbitrators to write an unpublished written decision that could be subpoenaed in an action to overturn an award. Of these, the first and fourth would be the easiest to implement, while the second and third may require congressional action to amend the Federal Arbitration Act, something that would not be undertaken lightly.

