Staff Findings on "Pre-Dispute" Survey

In early April 1988 SAC filed a Freedom of Information Act request for responses gathered in an SEC survey of broker-dealers regarding their use of pre-dispute arbitration clauses. We received the staff's response in early July. In the interim, the results of the survey had been tabulated and announced by the staff at the SEC's open meeting on June 1.

The October 1987 survey is now well-known as the basis for the staff's recommendation that the Commission consider legislative and regulatory action to restrict the use of pre-dispute clauses in customer agreements.

While declining to provide the raw material received in response to the survey, the staff did provide SAC an 8-page "Summary of Staff Findings," with exhibits. As some of the figures have been misreported elsewhere and some items have not received exposure, we provide this summary. As always, photocopies of the staff report are available to subscribers from SAC.

Survey Covers Most Accounts

The survey sample covered 65 broker-dealers, 25 of the largest NYSE members, the 20 largest NASD (non-NYSE) members, and a "cross-section" of other NASD firms, which together carry about 90% of the nation's brokerage accounts.

Eleven of the NASD firms did not carry margin accounts and at least six did not have retail accounts. Thus, the percentages reported were based only on those firms that had such accounts. The account number totals used include only those firms which provided figures. At least five of the NYSE firms did not provide statistical data, although they did respond to policy questions.

Of the 54 firms carrying margin accounts, 48 (89%) use arbitration clauses and 96% of the margin accounts reported are at these 48 broker-dealers. Approximately 5% of the margin accounts were opened before use of the clause began. Of the 54 firms carrying options accounts, 45 (83%) use arbitration clauses and 95% of the options accounts reported are at these 45 broker-dealers. Of the 59 firms carrying cash accounts, 29 (49%) use arbitration clauses, but only 39% of the cash account total is actually covered by arbitration clauses.

Negotiability of Clauses

Regarding their policies on waiving the arbitration provision for retail accounts, only four broker-dealers had written policies. These policies provide that the firm "generally will not permit" a waiver. Fifteen firms had unwritten policies to the same effect. Eleven reported that requests were resolved "on a case by case basis by senior personnel." Asked to estimate how frequently waivers were granted, only two offered estimates of "twenty-five accounts" and "a few accounts." Most responded that the data was impractical to retrieve and accurately determine.

There was little difference between NYSE and NASD firms' coverage of margin accounts (96% vs. 95%, respectively) and options accounts (95% vs. 91%, respectively). As to cash accounts, a surprising difference was revealed. Firms accounting for 46% of the cash accounts at NYSE firms use arbitration clauses, while firms accounting for 97% of the cash accounts at NASD firms include the clause in their cash account agreements.

Cash Account Coverage

Only 38% of the cash accounts at NYSE firms and 41% of the cash accounts at NASD firms are actually covered by arbitration clauses, perhaps because the policy as to cash accounts is more recent than for margin and option accounts. Three of the firms reporting use of the arbitration clause in cash accounts stated that the customer is not required to sign in order to open an account.

Two factors were noted as indicating that the percentage of cash accounts covered by arbitration clauses will grow. One is that those firms now requiring the clause in customer agreements will gain percentage through attrition, as older accounts leave or sign new agreements. The other is the reported intention of six firms, accounting for 42% of the NYSE cash accounts, to either add or consider adding the clause to cash account agreements.

In a footnote on this point, the staff notes that the Securities Industry Association completed a telephone survey of the eleven largest retail broker-dealers in May 1988 and reported "that while some of those firms had considered the use of predispute arbitration clauses for cash accounts, they had since rejected the idea." (In a recent article, SIA President Edward I. O'Brien elaborates on the survey results: "eight firms haven't any such pact for cash customers — the majority of their clients. Those that do wouldn't let it stand in the way of opening an account if the customer is opposed to it." See cit. at "Cases & Articles").

Cash account clients with margin or option account agreements may also be bound to arbitrate disputes relating to their cash account, since many such agreements relate to all transactions or controversies which may arise. The staff could not arrive at an estimate as to the number of cash accounts so affected, but did report that 44 of the 49 firms using arbitration clauses employ language to assure that transactions in all accounts are covered.

AAA As Forum Choice

The staff survey also canvassed the broker-dealers on whether they include AAA as a forum of choice in their arbitration agreements. Thirteen of the 49 (27%) firms using arbitration clauses include AAA. Two firms stated that, upon request of the customer, they would arbitrate at AAA. Five firms are considering whether to add AAA. The SIA model form for member firms provides AAA as a forum of choice.

Four firms reported prior inclusion

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SICA Adopts New Form of Award and Amends Fee Rules

The Securities Industry Conference on Arbitration met on June 28 at the New York Stock Exchange to consider a lengthy agenda. Among the items acted upon were two Rule amendments to the Uniform Code of Arbitration regarding party service of pleadings and fee revisions. The fee schedule itself does not change under the new Code provisions; rather, the changes codify fee practices at the major SRO's regarding the frequency with which the levy may be made.

"Hearing Session" Defined

The fee amendments provide specifically for additional filing fees for counterclaims, cross-claims, and third-party claims. Charges per hearing session remain the same, but SICA has defined a "hearing session" to be "any meeting between the parties and the arbitrator(s), including a pre-hearing conference, which lasts four (4) hours or less." The new definition makes it possible for arbitrators sitting through a full-day session to levy a multiple of the filing fee for the day's proceedings.

The UCA's Small Claims Procedure was revised by SICA to conform to the provision for party service of pleadings in cases over $10,000. At its May meeting, SICA approved new rules (See SAC, June '88) requiring parties to serve all pleadings, except the Statement of Claim, directly upon all other parties. The arbitration staff will continue to serve the initial Claim, but will then receive copies of all other pleadings from the parties responsible for effecting service.

NASD Demurs on Fee Cut

Though the fee changes were adopted as proposed, the Conference added two provisions which required the Rule to be returned to the drafting committee. First, SICA decided that the fee for a pre-hearing conference "hearing session" should only be 75% of the usual charge. Second, specific language will be added to clarify arbitrators' authority to award costs and expenses within the scope of the arbitration agreement and as otherwise permitted by law. (NASD recently filed its Rule amendments with the SEC, but in doing so provided for a 100% fee charge for pre-hearing conferences, notwithstanding the SICA revision.)

The drafting committee was delegated the additional task of composing language for two new Rules. The first relates to the classification of "public arbitrators." The issue of which arbitrators should be excluded from this classification has received considerable attention in prior Conference sessions. Substantial agreement has been reached concerning the exclusion of securities industry retirees, professionals who represent broker-dealers, and spouses of securities industry personnel. While some issues do remain, the consensus view supported drafting a Rule defining minimum standards for "public arbitrator" classification.

New Award Coming

The second new Rule relates to the contents and public availability of arbitration awards. The form of the SRO award is presented below. What remains to be settled is what information contained in the award will be made publicly available. The sensitive data, of course, are the names of the parties and the names of the arbitrators, probably in that order. Again, the consensus view of the Conference favored a Rule draft setting forth the form of the award and a separate paragraph describing what information will be made publicly available. It is the SEC's stated objective to achieve uniform agreement among the SRO's on this point.

Progress reports on other matters included a decision to continue a pilot program, under the auspices of the CBOE, to obtain party evaluations of arbitrators, a report concerning SRO case statistics for 1987, and an agreement in principle to rotate the terms of public members to the Conference.

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of AAA in the clause: "three of these firms explained that AAA was dropped because the firm had had unfavorable experience with AAA in the past. One firm stated that it had deleted AAA as one of the forum choices ... because the Commission does not have oversight authority over the AAA ..." Still, the staff notes that securities case volume at the AAA has been on the rise in recent years.

The survey results concerning cash accounts have been the most pivotal in the current controversy over pre-dispute agreements. Chairman Ruder has testified that, in good part, it was the threat of aggressive use of the pre-dispute clause in the cash account area that stimulated his concern for immediate action in June and indications that the threat had lessened which permitted his shift in July. Cash accounts are also his primary focus for imposing "free-choice" requirements regarding pre-dispute clauses.

The survey indicates the vast majority (13.6 million cash accounts in the survey universe versus 5.7 million margin and options account) of accounts are still cash accounts. Given estimates from one major retail firm that only about 20-25% of litigation arises from cash accounts, the search for a compromise, if the SEC insists on a "free-choice" requirement, could be to settle upon a distinction in treatment between cash and margin or options accounts.