THE PACIFIC STOCK EXCHANGE INCORPORATED

Dr. Maurice Mann
Chairman and
Chief Executive Officer

Via Facsimile/U.S. Mail

October 17, 1988

The Honorable David S. Ruder
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear David:

Re: Mandatory Predispute Arbitration Agreements: PSE Study

This letter responds to the Commission's request that the Pacific Stock Exchange (PSE) review the issues raised by member firms' use of mandatory predispute arbitration agreements. The request was contained in a letter from you to me, dated July 8, 1988.

For the past year, the PSE has worked closely with other SROs and with the Securities Industry Conference on Arbitration (SICA) to develop rules that will improve the arbitration process. At the end of October 1988, the PSE will submit a rule filing with the SEC, which is based on many of the SICA proposals. The rule filing is designed to improve overall efficiency of the arbitration process, to expedite the exchange of pleadings, to establish a formal discovery process, and to provide more information on the arbitrator's background and affiliations. Generally, the rule changes will give parties more rights in the processing of their case and should increase public perception of the fairness of the arbitration process.

The PSE believes that the arbitration forum it provides is fair and impartial. The Arbitrator Profiles it maintains assure that any arbitrator selected to determine a case has no affiliation with any party to the dispute. The PSE rarely receives complaints from participants in an arbitration hearing that the forum or the arbitrator(s) was biased.

In responding to your request, the PSE considered how it could best determine public investors' attitude to the predispute agreements. To this end, the PSE prepared a questionnaire, and mailed it to 83 public customers who had been involved in arbitration at the PSE since 1985. (The PSE decided not to survey member firms because it believes that the larger SROs are in a better position to do so, and because that field has been extensively covered already by both the SEC and other exchanges. It was anticipated, however, that there would be little contact with the public customers.) A copy of the questionnaire and a compilation of the responses are attached for your reference.

The PSE received 41 responses to the questionnaire. The PSE acknowledges that the sample used was small, and, therefore, the results have limited application. However, some interesting conclusions can be drawn from the responses.

Of the responses:

> 40 percent stated that their brokerage agreement did contain a predispute clause, 20 percent stated that there was no clause, and 52 percent did not know whether a clause existed.
>
> 19 respondents prevailed in their arbitration, and 17 lost. (Not all respondents answered this question.) Those who lost were generally unsatisfied with the arbitration process, felt that the arbitrators were biased in favor of the securities industry, and believed that they would have prevailed in court. On the other hand, those who prevailed were generally satisfied with the process, did not believe there was bias, and would be prepared to sign another predispute agreement.

Of those who prevailed, most appeared to have a greater knowledge of the arbitration process and the differences between arbitration and court litigation than those who lost.

The respondents were asked for suggestions as to how the process could be improved. Many of the respondents suggested that the entire process could have been faster. It was also suggested that more information explaining the process would have been helpful. It might be beneficial for SICA to develop a Public Customer Handbook for this purpose.

Based on its own research and in part on the response to the questionnaire, the PSE would like to address the following issues:

1. <u>Should broker/dealers be permitted to condition their services upon the execution of a mandatory predispute arbitration agreement?</u>

Some facts must first be stated in response to this question:

(a) Not all brokerage agreements contain predispute clauses. This is especially true of cash accounts. But even in options and margins accounts, not all firms require such

agreement.[1] Even where such a clause exists, a customer may request that it be stricken from the agreement, or modified to cover only certain situations. There are certain firms that will consider waiving the clause.[2]

(b) Arbitration in the securities industry is subject to strict scrutiny. The Uniform Code of Arbitration, developed by SICA, has been adopted by all the SROs that provide an arbitration forum. SICA has met almost every month in 1988, and has exhaustively discussed the issues raised by the McMahon decision. These discussions have led to proposals for rule changes to assure a fairer forum and to provide for a more expedited process. Some of these proposals are currently being reviewed by the SEC. (As stated above, the PSE's proposed rule changes will be submitted to the SEC before the end of October.)

In sum, the administration of the arbitration process by the securities industry is continually under review, not only for internal efficiency, but also to assure the protection of the public investor.

Given the above stated facts, the PSE believes that, in the vast majority of disputes, arbitration offers significant advantages to all parties, whether they are broker/dealers or public customers.

The PSE does not believe that the existence of mandatory predispute agreements have a negative impact on the industry or its customers. On the contrary, if such clauses were prohibited, the costs of litigation would likely fall to the customers, through higher commissions, or other charges.

2. Should mandatory predispute arbitration agreements be restricted to a dollar threshold, or denied to complex litigation or class actions?

For the same reasons stated above in #1, the PSE does not believe that restricting mandatory arbitration to below a certain dollar threshold offers any advantages or further protection to customers.

In addition, the PSE, along with most other exchanges, has a provision in its rules that allows the Exchange to decline the use of its arbitration facilities in any dispute, claim, or controversy, where having due regard for the purposes of the Exchange, and the intent of the rules, such dispute, claim, or controversy is not a proper subject matter for arbitration. If a claim is filed with the Exchange that is not appropriate or is better suited for resolution in court, the Exchange can and will deny arbitration.

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[1] SEC staff findings with respect to the use of Predispute arbitration clauses.

[2] Ibid.

3. Should a predispute arbitration clause be required to be on a separate document, requiring a separate signature? What kind of disclosure should be required concerning the clause?

The PSE favors the disclosure requirements for predispute arbitration clauses that were proposed at the SICA meetings in August and September, 1988. These requirements, agreed to by the participants at SICA, require the predispute clauses be highlighted, and specific disclosures be included with regard to arbitration.

Conclusion

The PSE believes that the SROs, through their involvement with SICA, are best positioned to provide the rules and procedures for the arbitration process, to provide protection to the customers, and to assure the fairness and impartiality of the arbitration process.

We would be pleased to address any further issues concerning this subject.

Sincerely,

Dr. Maurice Mann
Chairman and
Chief Executive Officer

Attachments
Ref. 2.Rud

THE PACIFIC STOCK EXCHANGE INCORPORATED

September 12, 1988

^F1^
^F2^
^F3^

Re: Predispute Arbitration Agreements

Dear ^F4^

The Pacific Stock Exchange ("PSE" or "Exchange") is conducting an examination of the use of arbitration clauses in customer agreements. We are contacting you to solicit your response regarding securities brokerage agreements which require disputes to be resolved solely through arbitration. These are generally termed "predispute arbitration clauses".

As you may know, recent court rulings and the events of October 1987 have significantly increased interest and awareness of securities arbitration on the part of state and federal governments, the Securities and Exchange Commission and public investors. The PSE recently received a letter from Chairman David S. Ruder of the SEC requesting that the PSE review the use of predispute arbitration clauses.

As a public customer who has been involved in arbitration here at the PSE, we believe that you would have useful information and insights. Your responses would greatly assist the PSE in its review.

Please take a few minutes to complete the following questions. Comments are not required, but they would be helpful. Please respond by no later than **Friday**, **September 23**, 1988. A pre-addressed, stamped envelope is enclosed for your use.

Thank you for your time and cooperation.

Very truly yours,

Theodore B. Crum
Director of Arbitration

TBC:jlc
Enclosures (Envelope & Questionnaire)

301 Pine Street, San Francisco, CA 94104 (415) 393-4000
233 South Beaudry Avenue, Los Angeles, CA 90012 (213) 977-4500

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Predispute Arbitration Agreements

QUESTIONNAIRE

1. Did a predispute arbitration clause exist in the agreement you signed to open the account that was involved in arbitration?

   Yes _____ No _____ Don't Know _____

2. If the answer to no. 1 was "Yes", were you aware of the clause at the time you opened the account(s)?

   Yes _____ No _____

   Comments:

3. If you checked "No" in no. 2, would you have opened your account if you had known that a predispute arbitration clause existed?

   Yes _____ No _____ Don't Know _____

   Comments:

4. Did you understand that the predispute arbitration clause contractually bound you to resolve any disputes through arbitration?

   Yes _____ No _____ Not Applicable _____

5. Was there any discussion about arbitration around the time you opened your account(s)?

   Yes _____ No _____ Not Applicable _____

   With whom?

   Please specify nature of discussion:

6. Did the brokerage house require you to specifically acknowledge the predispute arbitration clause as a condition of accepting your account?

Yes _____ No _____

Comments:

7. Given your recent experience with the securities arbitration process, would you consent to an agreement that contained an arbitration clause in the future?

Yes _____ No _____

Comments:

8. Would you choose a brokerage house on the basis that it did not require the resolution of disputes through arbitration?

Yes _____ No _____

9. Do you believe that brokerage houses should be able to condition their services on the execution of an agreement containing a predispute arbitration clause?

Yes _____ No _____

Please give reasons for your answer:

10. Does your answer to no. 9 above depend on the type of account being opened? For example, cash, margin, options?

Please explain:

11. Do you believe that complex claims, or claims in excess of a certain amount, (eg. $100,000) should be exempt from predispute arbitration clauses?

Please explain:

12. Use the following chart to indicate when you became aware of the facts in (a) through (e):

1 = Before Opened Account
2 = At Time Opened Account
3 = When Filed Claim
4 = After Filed Claim
5 = Just Now

a) Arbitration pursuant to customer agreement is mandatory, final, and binding on all parties.

Circle one: 1 2 3 4 5

b) All parties waive their rights to seek court remedies, including the right to a jury trial.

Circle one: 1 2 3 4 5

c) Prearbitration discovery is significantly more limited than in court proceedings.

Circle one: 1 2 3 4 5

d) Arbitration awards are not required to include factual findings or legal reasoning, and any party's right to appeal rulings is limited to extraordinary events.

Circle one: 1 2 3 4 5

e) A Hearing Panel will typically include a minority of arbitrators affiliated with the securities industry.

Circle one: 1 2 3 4 5

13. Given your experience with the securities arbitration process, would you have preferred to go to court?

Yes _____ No _____

Why?

14. Do you feel that the arbitration forum is biased in favor of the securities industry?

Yes _____ No _____

Why?

15. a) Did you prevail in your arbitration? Yes ____ No ____

b) Were you satisfied with the decision? Yes ____ No ____

c) Were you satisfied with the arbitration process? Yes ____ No ____

16. Do you have any suggestions to improve the arbitration process?

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FINDINGS FROM PREDISPUTE CLAUSE SURVEY

83 questionnaires were mailed out to Public Customers who had engaged in arbitration at the PSE over the past three years, 34 responded.

1. In complex cases over $100,000, all customers, whether they had won or lost their case, would have preferred the choice of presenting their case in court. (9,11)

2. Not one customer had any discussion with their broker concerning the Agreement. Many customers signed the Agreement without realizing what it meant. (5, 6)

   > "I unknowingly gave up my rights by not reading the fine print."

3. Whether customers favored or objected to the arbitration process and the predispute arbitration clause depended directly on whether they won or lost their case.

   a) Public customers who won their cases:

      - believed that Exchange sponsored arbitration was not biased in favor of the securities industry. (13)
      - were satisfied, in general, with the arbitration process and preferred it to the court system. (15b)
      - would sign another Predispute Clause (7, 8)

   b) Public customers who lost their cases:

      - felt the arbitrators were biased in favor of the securities industry. (13)
      - believed they would have prevailed in court (13)
      - were unsatisfied with the arbitration process (15b)

4. Those who won their case reported a greater knowledge of the characteristics of arbitration and the differences between arbitration and court proceedings. (1, 5, 4, 12)

Non-lawyer public customers are not familiar with the rules of law. They feel they are handicapped when they up against an attorney who knows the rules, is knowledgeable about the intricacies of the industry, is unemotionally involved in the case, and who is trained in the presentation of arguments and evidence. Claimants who represent themselves, particularly if they are not very educated and sophisticated, feel that the securities firms have an edge on them.

One respondent put it:

> "Biased may not be a good word, but the securities industry receives legal advice and is much more likely to be within legal bounds, even though rough on the customer, who usually has no such legal backup. That is, there is no question of sentiment… etc.. It seems to be cut and dried and in that case, the securities industry will win because by and large they won't "step over the line."

Another wrote:

> "Perhaps if neither side could bring their attorney, it might turn out fairer."

Other handwritten comments by respondents who lost consistently showed a lack of understanding and sense of bewilderment:

> "was not aware that security firm could have a lawyer present"
>
> "clients do not participate in selecting arbitrators"
>
> he would have preferred a court, "because then I could have an attorney and he could tell me what was happening. Without an attorney I don't know what is going on."

Note: It would have been interesting to hear from those who had legal representation and also from claimants' lawyers.

5. Summary of handwritten comments on what could be done to improve the system.

   a. Faster time to hearings.
   b. More detailed booklets or a video explaining process.
   c. More hearing locations.
   d. Impartial arbitrators.
   e. Reimbursement and damages for all costs.
   f. Punitive awards.

SUGGESTIONS

1. Provide statistics for customers on how many cases were decided in favor of the public customer and how many against.

   Statistics will provide the bottom line of proof to determine whether the Exchange's forums are biased or not. (By the way, it would be interesting to know how many claimants with lawyers, and without lawyers won their case to attest that you don't need a lawyer to win.)

2. Give a choice on large complex cases with some threshold figure.

   Complex cases over $100,000 (or some threshold figure) should have the option to go to court.

3. Have the Predispute Agreement be on a separate sheet of paper, with full explanations on it.

   (It is important that it is not written in complete "legalese" which makes the whole thing sound questionable to the non-lawyer. I saw a good one in the doctor's office, they are sending me a copy.)

4. Provide additional (to the current package) explanations of what the arbitration process entails, what to expect, and a brief very simple summary of legal thinking written by a non-lawyer (such as what "Discovery" is and some of its basic rules, and rules of evidence, etc.).

   The most startling concept to learn at the hearing for non-lawyers is that you pull a Perry Mason surprise witness out of the bag or present a last minute piece of important evidence. Most non-lawyers <u>do not know</u> that you must show <u>all</u> your evidence and identify all of your witnesses to the other side <u>before</u> the hearing, and that the other side must do the same for you.

   Describe how to present a case at the hearing, eg. describe the opening statement, presentation of case, direct and cross-examination, etc.

5. Expedite process. (Ideas in progress.)

PREDISPUTE QUESTIONNAIRE ANSWERS

Questions in which win/lose related

Question Number	Won	Lost
1. a) Agreement contained clause	10	3
b) Agreement did not contain clause	4	3
c) Don't know	7	11
2. a) Was aware of Clause	5	1
b) Was not aware of Clause	5	7
4. a) Understood Clause was contractually binding	10	5
b) Did not understand Clause was contractually binding	5	7
5. There was no discussion of Clause	18	17
6. Was not required to acknowledge Clause	16	17
8. a) Would not choose brokerage house because it had Clause		
9. a) Broker should be permitted to condition services on Clause	9	11
b) Broker should not be permitted to condition services on Clause	5	11
11. a) Should exempt $100K claims	13	14
b) Should not exempt $100K claims	14	5
12. People who won arbitration cases were more likely (on a 2 to 1 basis) to understand the characteristics of arbitration.		
13. a) Would have preferred court		17
b) Would not have preferred court	16	
14. a) Believe the forum was biased		18
b) Believe the forum was not biased	15	

Quotes from those who LOST

"The arbitration process was confusing."

"The PSE is clearly an arm of the brokerage firms. There is a friendly attitude toward member firms."

"It is weighted totally in favor of the brokerage house."

"…I'm disgusted with the whole industry – like doctors, they protect their own. Perhaps if neither side could bring their attorney, it might turn out fairer."

"Use an organization in no way associated with the brokerage firms."

"They require much more evidence from the complainant than the Stockbroker."

Quotes from those who WON

"Arbitration is cheaper, faster and fairer than court.

"Panel is chosen from impartial arbitrators."

"I don't believe small claims courts are competent enough to handle disputes up to $1500 and it would be expensive to hire a lawyer."

"It is too expensive for a small investor to hire an attorney and sue in most cases."

Preferred arbitration because in court, "It would have taken longer and because the broker has an attorney on retainer or part of their staff. I would have been at a disadvantage."

"…Any dispute should be settled by the broker himself and not the firms legal staff."

"For many people, the process probably requires more detailed explanation than that provided to me in the PSE booklet. Arbitration …. is probably the best solution for fairly small, uncomplicated claims."

"It saves time and money for both parties."

"The arbitration process is much easier and less expensive, you can do it without a lawyer if you have your facts."

"Arbitration is fast and inexpensive – otherwise I would love to resort to lengthy and costly court action."

"Arbitration is the least expensive, quick and effective method of solving customer disputes. It makes brokerage houses more accountable."

"I think it works pretty well, certainly for minor claims like mine, It's the way to go. We don't need more, silly lawsuits actually which only serve to feed lawyers."

"…arbitration is fairer and better for all concerned than litigation ….. Also, I believe that due to competition, brokerage houses basically want to do well and satisfactorily serve their customers."