Quantification and Damages in Broker Liability

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Overview

- Fundamental legal principles in broker liability
- Quantification issues arising in the case law
  - Offset
  - Hypothetical portfolio
  - Strategies to reduce damages
- The expert perspective
  - Client risk and objectives
  - Suitability
  - Determining harm
Fundamental Legal Principles

- Brokers are generally liable in negligence
  - Claims for breach of contract or breach of fiduciary duty can be brought too, but the quantification analysis does not change
- A damages award must return the client to the position he or she would have been in absent the broker’s negligence
- But the client must not be put in a better position
Major Quantification Issues

- Can the broker offset negligent transactions that harm the client with negligent transactions that benefit the client?
- How would the client have fared absent the broker’s negligence?

- Broker liable for making six unauthorized transactions in a client’s account
- Four of the transactions lost money, but two resulted in profits
- Broker wanted to offset profitable transactions against losing ones
Sharpe: BCCA Judgment

- The transactions in this case were separate and distinct
- Client entitled to claim for some transactions and not others
- Broker cannot offset profitable transactions against losing ones
Zraik v. Levesque Securities Inc., 2001 ONCA 21223

- Successful commodities trading from July 1993 until February 1995, at which point $400,000 was lost in six weeks
- Trial judge offset $140,000 earned in 1993 and 1994
- Reversed on appeal
Zraik: ONCA Judgment

“Each case must turn on its own facts, but…I find offensive the notion that a brokerage firm, when called to account for a disastrous series of trades that were the direct consequence of its lack of supervision of the account, can defend on the basis that it is entitled to an offsetting credit for profits in earlier years when they were every bit as lax in supervising the account…”

Followed in 2878852 Canada Inc. v. Jones Heward Investment Counsel Inc., 2007 ONCA 14
Marlin Investments Inc. v. Moldovan, 2014 BCCA 36

- Client invested in a high-risk options program involving monthly transactions
- Options program not appropriate for the octogenarian client living on CPP
- Broker liable in negligence for breaching the “Know Your Client” rule
- Options program led to profits in early years, but caused significant losses in late 2008
Marlin Investments: Portfolio Returns

- Portfolio Opened: $0
- 1 September 2008: $98,000
- Portfolio Closed: - $213,000
**Marlin Investments: Damages**

- **Portfolio Opened**: $0
- **1 September 2008**: $98,000
- **Portfolio Closed**: - $213,000

**Client's Claim**: $311,000

**Broker's Calculation**: $213,000
Marlin Investments: Submissions

- **Client:**
  - As in *Sharpe* and *Zraik*, the broker is not entitled to offset profits against losses
  - The client is allowed to set the claim period

- **Broker:**
  - *Sharpe* and *Zraik* are distinguishable: this case concerns a continuous strategy of linked transactions
  - The program as a whole was unsuitable, not the individual transactions
Marlin Investments: BCCA Judgment

- *Sharpe* and *Zraik* are distinguishable: the transactions were not separate and distinct
- Client must be put in the position it would have been in had it never been involved in the options program
- Damages are the difference between that position and the position it was in after participating in the options program
- Broker successful; damages of $213,000
The Hypothetical Portfolio

- Broker liability cases often result from a broker selecting or recommending investments inappropriate for the plaintiff client.
- Presumably, many plaintiff clients would have invested in appropriate investments instead.
- Courts have awarded damages for the lost opportunity to invest in appropriate investments.
Marlin Investments: The Hypothetical Portfolio

“…a number of the cases in this area assess damages arising out of a broker's negligence by constructing a hypothetical portfolio of appropriate investments, looking at the experienced returns therefrom, and comparing those returns to the losses experienced by the plaintiff in the inappropriate investments…”
Marlin Investments: The Hypothetical Portfolio

“...[this methodology] may well be preferable in most cases. However, neither party submitted this methodology should be used and I am satisfied that, in the particular circumstances of this case, the trial judge’s alternative approach to assessing damages is sound.”
Client had filled out an investment form with the following “investment objectives”

- 10% Income
- 40% Long Term Growth
- 10% Short Term Trading
- 40% Speculative
Hawkenson: Facts

- The “Speculative” portion of the portfolio regularly exceeded 40% and was sometimes as high as 60%
- Broker liable in negligence for failing to meet industry standards for supervising the portfolio and advising the client of losses in the portfolio
- If account was properly supervised, the 10/40/10/40 profile would have been maintained
Hawkenson: Calculation of Damages

- Appropriate to compare the performance of the client’s actual portfolio with a hypothetical portfolio that fit the 10/40/10/40 profile
- The court had enough information to calculate the performance of a hypothetical portfolio
- This approach likely reduced damages: the actual portfolio lost over $500,000 during the relevant period, but damages were $234,000
Marlin Investments: Possible Outcome with a Hypothetical Portfolio

Actual Damages: $213,000

Hypothetical Portfolio Damages: less than $213,000
Calculating the Hypothetical Portfolio

- Expert evidence is required, based on:
  - The client’s stated investment objectives (Hawkenson)
  - The client’s investments with a subsequent non-negligent broker (Ridel v. Cassin, 2013 ONSC 2279)
  - An estimate based on the actual losses suffered by the client (Secord v. Global Securities Corp., 2000 BCSC 1544)
Opportunity Cost v. Absolute Loss

- Should it be conceded that full opportunity costs are necessarily the appropriate measure of damages?
- What if it is a case in which only one or very few securities were unsuitable? (\textit{Stradiotto v. BMO Nesbitt Burns}, 2014 ONSC 3477)
- What if the plaintiff fails to present a damages expert or the expert’s opinion is highly speculative or unrealistic? (\textit{Blackburn v. Midland Walwyn Capital Inc.}, 2005 ONCA 4263)
- Is the absence of a fiduciary duty relevant? (\textit{Davis v. Orion Securities Inc.}, 2006 ONSC 26966)
Other Strategies for Reducing Damages

- Plaintiff’s duty to mitigate in accordance with the factors outlined in *Hunt v. TD Securities Inc.*, 2003 ONCA 3649
  - Ease of purchase of replacement shares
  - Degree of sophistication and experience
  - Degree of trust
  - Whether the broker was obliged to obtain client instructions for trades
  - Whether the relationship had broken down to the point of loss of confidence in the broker
- Narrowing/widening the relevant time period
- Contributory negligence
Conclusions

- There are no “offsets” between negligent transactions that benefit a client and negligent transactions that harm a client
- Courts will determine whether transactions are discrete (Sharpe and Zraik) or part of an ongoing strategy (Marlin Investments) and quantify damages accordingly
Conclusions

- Courts are willing to use a hypothetical portfolio to quantify damages
  - More likely to be used when an entire portfolio is inappropriate, as opposed to only a few investments (*Stradiotto v. BMO Nesbitt Burns*, 2014 ONSC 3477)
  - May reduce damages in some cases, but requires expert evidence
Conclusions

- General legal principles, including regarding mitigation, betterment and contributory negligence, apply equally in broker liability cases
- Imaginative application of these general principles can help to reduce damages awards
Client Broker Disputes
Towards a Fairer Resolution of Liability and Loss Quantification

Michael Dobner, Partner
Valuations Modelling and Disputes


**Agenda**

- Introduction
- Determination of the Client Risk and Objectives
- Suitability Analysis
- Determining Financial Harm and Compensation
- Case Study
Introduction

- Majority of disputes involve allegations of poor advice, unsuitable investment strategies and under performance.
- As a result investors ask for compensation.
- To determine the loss, if any, we need to conduct 3 steps:
  - Determination of the Client Risk and Objectives
  - Suitability Analysis
  - Determining Financial Harm and Compensation
**Determination of the Client Risk and Objectives**

- Review of the relevant forms completed by the broker.
- In many cases, investors allege that their information:
  - Was not accurately recorded;
  - That they did not understand the forms they signed; and/or
  - That their advisor did not review the forms with them or explain their significance.
Determination of the Client Risk and Objectives - Investigation

- Interviews with the broker and the investor;
- Review of the client’s circumstances and the common risk and objectives that relate to such circumstances;
- Consideration of industry standards and common practices; and
- Review of the investor’s behavior in other cases.
Suitability Analysis
Principles of the Portfolio Method

• Measured with objective tools.
• Standard deviation (i.e. volatility) is a statistics term that is widely accepted as a risk measurement (i.e. the higher the volatility of the portfolio the higher the risk).
• The combined standard deviation of a portfolio of risky securities can be lower than each of the standard deviation of securities in that portfolio.
• Measuring suitability should not be made on a security by security basis.
• Volatility of the capital markets changes over time and so does the notion of risk.
Suitability Analysis
Application of the Portfolio Method

- Given the profile of the client a proxy portfolio can be identified.
- A proxy portfolio can be based on a recognized and accepted benchmark such as an index, ETF or mutual fund.
- Independent and reputable sources provide regular analysis on the risk profile of such benchmarks.
- Suitability can be evaluated by measuring the standard deviation of the proxy portfolio to the standard deviation of the actual portfolio at relevant points of time.
Suitability Analysis
Application of the Portfolio Method (Cont’d)

• Measure the standard deviation of the proxy portfolio to the standard deviation of the actual portfolio at the relevant points of time.

• The actual portfolio will be considered suitable if at the relevant points in time its volatility was not statistically different than the volatility of the proxy portfolio.

• A statistical test could be performed to measure weather the volatility of the actual portfolio was significantly different than the proxy’s volatility on the relevant dates.

• In this manner suitability could be measured on a continuum over the period alleged by the investor.
Suitability Analysis
Benefits of the Portfolio Method

The Portfolio Method overcomes issues such as:

a) Subjectivity
b) Existence of low and high risk investments in the same portfolio
c) Ability to measure deviations from investor instructions on short time intervals
d) Dealing with margin accounts
e) Dealing with short positions
f) Changes in investor instructions over time
Determining Financial Harm and Compensation

- If it was found that the actual portfolio failed the suitability test in any period then a quantification of losses should be perused for each of these periods.

- The performance of the actual portfolio and proxy portfolio should be measured for each of the deviation periods.

- The loss is calculated as the cumulative return of the proxy during deviation periods less the cumulative return on the actual portfolio during the deviation periods.
Case Study

Facts

- Investor wants a growth portfolio with medium risk or similar to the risk of the stock market as a whole
- Investment of $1 million
- Assume such profile corresponds to a volatility of approximately 20% per annum
- The broker invests in two securities one $0.5 million each with volatility of 40%. However the return on these two securities tend to have a negative correlation of 50%
- After a year the portfolio lost 15% (or $150,000) while the market was flat
Case Study

Results

• Ignoring the portfolio effect, it will be determined that each of the securities is more risky than the risk profile of the investor, thus the broker is liable for $150,000

• However, the total volatility of the portfolio is 20% or consistent with the investor’s risk profile

• Under the Portfolio Method there would be no basis for liability