# MARKET ADJUSTED DAMAGES IN THE FINRA FORUM

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## I. INTRODUCTION

Investors open accounts with brokerage firms to increase the value of their principal consistent with their time horizon, investment objectives and risk tolerance. It is logical for a client to seek and recover market adjusted damages when a brokerage firm recommends securities or pursues strategies that are inconsistent with the client's objectives.

Market adjusted damages utilize industry benchmarks to compute what an investor would have received had the portfolio been properly invested. These damages compensate an investor for losses caused by wrongful conduct in both a rising and falling market by adding or reducing return according to the actual performance of the market.[1]

This article discusses how an award of market adjusted damages should be pursued in the FINRA forum by a review of FINRA guidance, case law and practical application. This article concludes that market adjusted damages are an accurate and fair measure of compensation that appropriately reflects the harm caused to the investor adjusted for actual market performance.

## II. ASSET ALLOCATION AND DIVERSIFICATION

"A review of historical data and empirical studies provides strong support for the contention that the asset allocation decision is a critical component of the portfolio management process."[2] In fact, it has been recognized that "… the most important part of [investment] policy determination is asset allocation."[3] Studies have demonstrated that 90% or

1. "Market adjusted damages" are known by many names, including, *inter alia*, properly-managed account damages, well-managed account damages, *Miley* damages, and lost profits damages. For purposes of this article we will refer to them as market adjusted damages.

2. FRANK K. REILLY & KEITH C. BROWN, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 57 (8th ed. 2005).

3. ZVI BODIE, ALEX KANE & ALAN J. MARCUS, INVESTMENTS 946 (6th ed. 2005).

more of the performance in an investment portfolio returns are driven by the asset allocation decision.[4]

Courts have recognized that a brokerage firm can manage the inherent risk of the market through asset allocation amongst negatively correlated asset classes and diversification within each class.[5] It has been held that stockbrokers have fiduciary duties including full and fair disclosure of all material facts regardless of whether or not an investor is sophisticated or unsophisticated:[6]

> Twomey remains the controlling statement of the law applicable to this case. Contrary to appellants' position the relationship between a stockbroker and his or her customer is fiduciary in nature; the distinction between a "sophisticated" investor and an "unsophisticated" one is not controlling in this regard.[7]

Additionally, brokers and brokerage firms have an independent duty to investigate securities to determine whether they are consistent with a client's investment objectives and risk tolerance:

> Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act. Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein. The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard. Even where the purchaser follows the market activity of the stock and does not rely upon the salesman's statements, remedial sanctions may be imposed since reliance is not an element of fraudulent misrepresentation in this context.[8]

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4. *E.g.,* Gary Brinson et al., *Determinants of Portfolio Performance II: An Update*, FIN. ANALYSTS J. (May-June 1991); Roger G. Ibbotson & Paul D. Kaplan, *Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?*, FIN. ANALYSTS J. (Jan.-Feb. 2000).

5. A private cause of action for failure to diversify has been recognized. *See* Liss v. Smith, 991 F. Supp. 278, 301 (S.D.N.Y. 1998).

6. *See* Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1533 (Cal. Ct. App. 1981).

7. *Id.*

8. Hanly v. Sec. & Exch. Comm'n, 415 F.2d 589, 595-96 (2d Cir. 1969) (footnotes omitted).

A brokerage firm that fails to invest a customer's portfolio with an appropriate asset allocation among negatively correlated asset classes and diversification within each class may be held responsible for a breach of duty. This conduct may also constitute a failure to comply with the standard of care in the financial services industry.

## III. FINRA GUIDANCE ON AWARDING MARKET ADJUSTED DAMAGES

FINRA recognizes the importance of asset allocation and managing investment risk:

> In big-picture terms, managing risk is about the allocation and diversification of holdings in your portfolio. So when you choose new investments, you do it with an eye to what you already own and how the new investment helps you achieve greater balance. For example, you might include some investments that may be volatile because they have the potential to increase dramatically in value, which other investments in your portfolio are unlikely to do.
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> Whether you're aware of it or not, by approaching risk in this way—rather than always buying the safest investments—you're being influenced by what's called modern portfolio theory, or sometimes simply portfolio theory. While it's standard practice today, the concept of minimizing risk by combining volatile and price-stable investments in a single portfolio was a significant departure from traditional investing practices.
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> In fact, modern portfolio theory, for which economists Harry Markowitz, William Sharpe, and Merton Miller shared the Nobel Prize in 1990, employs a scientific approach to measuring risk, and by extension, to choosing investments. It involves calculating projected returns of various portfolio combinations to identify those that are likely to provide the best returns at different levels of risk.[9]

Additionally, the FINRA Dispute Resolution Arbitrator's Guide in explaining different remedies available, recognizes that well-managed account damages (*i.e.,* market adjusted damages) can be awarded:

9. FINRA, *Managing Investment Risk, Modern Portfolio Theory*, http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/ManagingInvestmentRisk/ (last visited May 8, 2014).

### WELL-MANAGED PORTFOLIO ACCOUNT

> This measure of damage allows the claimant to recover the difference between what the claimant's account made or lost versus what a well-managed account, given the investor's objectives, would have made during the same time period.[10]

FINRA's well managed portfolio remedy is consistent with FINRA's know your customer and suitability rule:

### 2090. KNOW YOUR CUSTOMER

> Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.[11]

### 2111. SUITABILITY

> (a) 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. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[12]

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10. FINRA Dispute Resolution Arbitrator's Guide 63 (Feb. 2014 ed), http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p009424.pdf (last visited May 8, 2014).

11. FINRA Rule 2090 (Know Your Customer), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858(last visited May 8, 2014).

12. FINRA Rule 2111 (Suitability), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 (last visited May 8, 2014).

## IV. CASE LAW AWARDING MARKET ADJUSTED DAMAGES

For years, courts have explored awarding market adjusted damages in securities cases involving churning and unsuitable portfolios. The accepted practice in securities cases involving churning and unsuitable portfolios is to calculate damages based on net economic loss or market indexing (such as the Barclays Aggregate Bond Index, Vanguard Total Bond Fund, S&P 500, Dow Jones Industrial Average, or similar benchmarks), regardless of whether state or federal law applied.

The Second Circuit in *Rolf v. Blyth, Eastman Dillon & Co., Inc.,* provided a road map for calculating damages using market indexing.[13] In that case, an investor brought an action against his broker and the brokerage firm seeking damages for stock market losses.[14] Rolf's long term advisor retired and his account was reassigned to a broker and an investment advisor who would collectively manage his accounts.[15] The investor's long term investments goals and strategy emphasized preservation and growth of capital for which he executed an authorization giving his broker full trading authority.[16] Over the course of a year, the value of the investor's portfolio dropped by approximately 70% as the result of purchasing risky securities.[17] The District Court for the Southern District of New York found the broker and brokerage firm liable.[18] The court reasoned that the broker owed a fiduciary duty to the investor which he breached which aided and abetted the investment advisor's fraud.[19] Additionally, the court found the brokerage firm liable under the doctrine of "respondeat superior or the securities law doctrine of controlling person liability."[20] The court then limited the damage award and failed to take into account market adjusted damages.[21] The broker and brokerage firm appealed the decision and the investor cross-appealed the

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13. Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 49 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978), *modifying*, 637 F.2d 77 (2d Cir. 1980).

14. *Id*. at 38, 41.

15. *Id*. at 41-42.

16. *Id*. at 42.

17. *See id*. at 42.

18. *Id*. at 38, 41.

19. *Rolf*, 570 F.2d at 43.

20. *Id.*

21. *Id.*

district court's measure of damages.[22] The Court of Appeals for the Second Circuit affirmed the broker and brokerage firm's liability and remanded the damage calculation back to the district court.[23] The Second Circuit acknowledged that while it was not capable of measuring the investor's damages, it disagreed that the damages should be limited to those arising in a churning case *(i.e.*, commissions).[24] Therefore, the Second Circuit set forth the following guidelines for the district court to follow when calculating damages on remand:

> First, the district court should determine as near as possible the time when [the broker] began to aid and abet [the investment advisor's] fraud and compute the market value of [the investor's] portfolio on that date. Second, the district court should subtract the value of the portfolio on the date when [the broker's] participation in and assistance to the fraudulent scheme ceased from the value on the date when [the broker] became and aider and abettor. This amount is [the investor's] gross economic loss. The district court should then reduce [the investor's] gross economic loss by the average percentage decline in the value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with [the broker's] aiding and abetting and terminating with its cessation.[25]

The court further explained the investor's gross economic loss calculation as follows:

> Here [the broker's] participation in [the investment advisor's] fraud infected [the investor's] portfolio during a specific period of time to be determined on remand. In a sense the portfolio will be deemed sold as of the last day of the aiding and abetting period in order to determine what the resale price would have been if the portfolio had been liquidated on that day.[26]

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22. *Id*. at 38, 41.

23. *Id*. at 38, 41, 48, 49-50.

24. *Id.* at 48.

25. *Id.* at 49 (citations omitted); *see also In re* Drexel Burnham Lambert Group, Inc. 161 B.R. 902, 909 (S.D.N.Y. 1993) (the measure of damages for unsuitability claims is the plaintiff's gross economic loss, adjusted for the overall market's performance citing *Rolf v. Blyth Eastman Dillon & Co*).

26. 570 F.2d at 49, n.21.

The court also acknowledged that the use of the market indices does not hold the broker and brokerage firm responsible for the general decline in the market:

> [the investor's] portfolio, even if it had not been fraudulently mismanaged, would have declined in value during the bear market of the aiding and abetting period. [The broker] and [brokerage firm] have no responsibility for the general decline in economic conditions.[27]

Shortly thereafter, in *Miley v. Oppenheimer & Company, Inc.,* the Court of Appeals for the Fifth Circuit approved the market adjusted damage calculation utilized in *Rolf*.[28] In *Miley*, an investor sought to recover damages based on federal securities law, common law and statutory law against his brokerage firm and two of its registered representatives for the churning of his account.[29] The District Court for the Northern District of Texas found that the brokerage firm and registered representatives breached their fiduciary duties to the investor and awarded actual and punitive damages.[30] The brokerage firm and registered representative appealed.[31] On appeal, the Fifth Circuit affirmed the district court's decision and discussed damages at length.[32] The court found, *inter alia*, that the investor was "entitled to recover the difference between what he would have had if the account had been handled properly and what he in fact had at the time the violation ended with the transfer of the account to a new broker.[33] In making these findings the Fifth Circuit reasoned:

> The investor is harmed by the decline in the value of his portfolio - the "spilt milk" of the churning violation - as a result of the broker's having intentionally and deceptively concluded transactions, aimed at generating fees, which were unsuitable for the investor. The intentional and deceptive mismanagement of a client's account, resulting in a decline in the value of that portfolio,

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27. *Id.* at 49, n.22.

28. Miley v. Oppenheimer & Co., 637 F.2d 318, 318 (5th Cir. 1981), *abrogated by* Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985).

29. *Id.*

30. *Id.* at 318, 325.

31. *Id*.

32. *Id.* at 326-29.

33. *Id.* at 327.

> constitutes a compensable violation of both the federal securities laws and the broker's common law fiduciary duty, regardless of the amount of the commissions paid to the broker. In sum, once a jury finds that the broker has churned an investor's account, it may also find that the investor would have paid less commissions and that his portfolio would have had a greater value had the broker not committed the churning violation...[34]

The Fifth Circuit recognized that although calculation of market adjusted damages may not be exact, "... neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case."[35] Additionally, "a refusal by a court to estimate the amount of trading losses caused by the churning of an account could only yield a certain windfall for either the investor or the broker."[36] Therefore, the court stated:

> In order to approximate the trading losses caused by the broker's misconduct, it is necessary to estimate how the investor's portfolio would have fared in the absence of [sic] such misconduct. The trial judge must be afforded significant discretion to choose the indicia by which such estimation is to be made, based primarily on the types of securities comprising the portfolio. However, in the absence of either a specialized portfolio or a showing by either party that a different method is more accurate, it seems that the technique discussed [in *Rolf*]… and employed by [the district court judge] in this case is preferable… This mode of estimation utilizes the average percentage performance in the value of the Dow Jones Industrials or the Standard and Poor's Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct.[37]

Further the Fifth Circuit acknowledged that market adjusted damages "attempt to prevent a windfall to either the injured investor or the wrongdoer, regardless of whether the misconduct at issue is viewed as federal or state law violation."[38]

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34. *Miley*, 637 F.2d at 326 (footnote omitted).

35. *Id.* at 327.

36. *Id.* at 328.

37. *Id.* (footnote and citations omitted).

38. *Id.* at 329. *See also* Donovan v. Bierwirth, 754 F.2d 1049 (2d Cir. 1985), which adopted the market index approach where a breach of fiduciary duty was found under ERISA:

The Ninth Circuit in *Hatrock v. Edward D. Jones & Co.* adopted the *Miley* analysis for market adjusted damages in churning cases.[39] In that case, customers brought suit against their broker and brokerage firm for misrepresentations and churning in the District Court of Idaho.[40] A jury returned a verdict in favor of the investors and awarded compensatory damages, punitive damages and attorneys' fees against the broker.[41] Thereafter, the broker and brokerage firm appealed and the investors cross-appealed.[42] In affirming the lower court's ruling, the Ninth Circuit addressed the damages an investor can recover for churning as follows:

> …when a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business, the customer may hold the broker liable for churning without proving loss causation. The investor may recover excessive commissions charged by the broker, and the decline in value of the investor's portfolio resulting from the broker's fraudulent transactions. The recoverable decline in portfolio value is "the difference between what [the plaintiff] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended." The finder of fact "must be afforded

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> One appropriate remedy in cases of breach of fiduciary duty is the restoration of the trust beneficiaries to the position they would have occupied but for the breach of trust.... [w]e hold that the measure of loss applicable under ERISA section 409 requires a comparison of what the Plan actually earned on the Grumman investment with what the Plan would have earned had the funds been available for other Plan purposes.
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> In determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions. Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them.

*Id.* at 1056.

39. Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 773-74 (9th Cir. 1984).

40. *Id*. at 767-70.

41. *Id.*

42. *See Id*.

> significant discretion to choose the indicia by which such an estimation is made, based primarily on the types of securities comprising the portfolio."[43]

Likewise, the District Court of New Hampshire in *Winer v. Patterson* found *Miley* and its progeny persuasive for the computation of damages in a churning case. [44] In *Winer*, the investor brought suit against his former stockbroker for violations of federal and state securities law and common law.[45] The broker moved for summary judgment or for an order *in limine* regarding the proper measure of damages.[46] In denying the broker's motion for partial summary judgment or, in the alternative, for an order *in limine*, the court reasoned:

> The Court finds the analysis in *Miley v. Oppenheimer*, *supra*, and its progeny to be persuasive and accordingly holds that should churning liability be established, plaintiff is entitled to recover the difference between the value of his account after the churning and what its value would have been absent the violation. Given that this is the proper standard, the Court can conceive of no reason to exclude recovery of the profits plaintiff's account would have earned absent the churning, provided that plaintiff meets his burden of establishing that this would have occurred and in what amount. While the Court is aware that some uncertainties in establishing these damages are unavoidable, plaintiff will have to present testimony to support his claim that he has lost profits in the amount of "at least $21,952.00." To this end, plaintiff must establish that comparison of the performance of his account to that of the DJIA would be an accurate measure of how his portfolio would have fared; the Court is not willing to blindly accept such a comparison as the proper method to measure lost profits. Moreover, given that the Court finds that plaintiff is entitled to collect damages so as to put him in the position in which he would have been but for the alleged churning, there is no support for plaintiff's claim that he is entitled to twice recover the excess commissions paid.[47]

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43. *Id*. at 773-74 (citations and footnotes omitted).

44. Winer v. Patterson, 644 F. Supp. 898, 900-01 (D.N.H. 1986), *order vacated in part on reconsideration*, 663 F. Supp. 723 (D.N.H. 1987).

45. *Id.* at 898-99.

46. *Id.*

47. *Id*. at 900-01 (citations and footnotes omitted).

The theory of market adjusted damages has also been adopted in the District Court for the Western District of New York. In *Medical Associates of Hamburg, P.C. v. Advest, Inc.*,[48] the parties brought competing motions for summary judgment regarding the appropriate measure of damages to be awarded.[49] Relying on the Second Circuit's opinion in the *Rolf* case, the district court rejected the brokerage firm's argument that the market index approach was appropriate only when the overall market declined during the relevant time period.[50] In rejecting the brokerage firm's approach to damages, the court reasoned:

> The defendants' distinction is untenable. *Rolf* laid no stress on the direction of the shift of the stock market in fashioning its market adjusted damage formula, and the defendants have not advanced a reasoned basis for enabling this Court to do so. Obviously, as in *Rolf*, where the securities market is in decline over the relevant period, a decline in a plaintiff's particular portfolio is partially attributable to market forces (instead of the defendant's fraud) and the plaintiff's recovery should thus be reduced accordingly to reflect his "actual damages." By the same token, as in this case, where a plaintiff's portfolio declines in value notwithstanding an overall rise in the market, such plaintiff's actual injury is not limited to the simple decline in value of his securities but encompasses also damages occasioned by the failure of such securities to keep pace with the market - as they otherwise generally would have.[51]

Accordingly, the court denied the brokerage firm's motion for summary judgment and granted the investor's request for the use of market adjusted damages.[52]

The Eighth Circuit in *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* upheld an award of market adjusted damages where the investor made a profit despite churning.[53] In *Davis*, the investor brought suit against the brokerage firm for violations of federal securities law, common-law fraud

48. Medical Associates of Hamburg, P.C. v. Advest, Inc.*,* No. CIV–85–837E, 1989 WL 75142, at *1 (W.D.N.Y. July 5, 1989).

49. *See id.*

50. *Id.*

51. *Id.* at *2 (citations omitted).

52. *Id.* at *3.

53. Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1218 & n.13 (8th Cir. 1990).

and breach of fiduciary duty. In the first trial, the jury awarded compensatory damages and punitive damages.[54] The brokerage firm then filed post-trial motions for judgment notwithstanding the verdict, new trial or remittitur.[55] The district court granted the brokerage firm's motion for remittitur (reducing the punitive damage claim) on the condition that the investor accepts remittitur or a new trial would be granted on the issue of damages.[56] The investor refused remittitur and a second trial followed wherein the jury again awarded compensatory and punitive damages.[57] On appeal, the Eighth Circuit addressed, *inter alia*, the award of compensatory damages as follows:

> We disagree with [the brokerage firm's] argument that no actual damages were sustained because after deducting the unauthorized commissions, the account nevertheless realized a cumulative net profit of over $53,000 during the period it was churned. The implications of this argument are disturbing. If we were to adopt [the brokerage firm's] view, securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested. Churning is not excused by the fact that the account realizes a new profit. In *Nesbit*, 896 F.2d at 386, the Ninth Circuit refused to offset the gains in portfolio against the losses in commissions. The court held that allowing securities customers to recover compensatory damages in the amount of excess commissions even when the account realizes a profit will have the salut[a]ry deterrent effect of "inform [ing] the brokerage community that churning is a fraud that will violate the securities laws, regardless of the ultimate condition of the client's portfolio." *Id.* We agree. Churning is a species of fraud prohibited by Section 10(b) and Rule 10b(5) regardless of whether the account's profits or its principal is misappropriated. Under the law of this circuit, if an account earned $50,000 but would have earned $100,000 if it was not churned, the customer has sustained actual damages in the amount of $50,000 plus excess commissions paid. Because [the investor] paid over $40,000 in commissions and would have earned over $50,000 more

54. *Id.* at 1210-12.

55. *Id*.

56. *Id*.

57. *Id.*

> than she did had her account not been churned, it is nonsensical to argue that she did not suffer actual damages as a result of the churning.[58]

More recently, in *Scalp & Blade, Inc. v. Advest, Inc.*, the Supreme Court, Appellate Division, Fourth Department, New York, held that gross economic loss adjusted for the market's performance is an appropriate measure for damages in cases involving churning, unsuitability, or unauthorized trading wherein a fiduciary duty was breached.[59] In that case, investors brought suit against a broker and brokerage firm for the mismanagement, including churning, of their trust fund held in an investment account.[60] In *Scalp*, the investors were a non-profit corporation that administered a scholarship program which was funded through income/gains from a trust fund held in an investment account.[61] The investors alleged that the broker failed to diversify assets and engaged in an excessive number of unsuitable transactions while in the course of his employment, with and under the supervision of, the brokerage firm.[62] Further, the investors alleged that as a consequence of the broker's wrongful conduct the trust fund fell approximately 50% in value during a time period in which the trust could have doubled in value had it been invested in suitable securities as measured

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58. *Id.* at 1218-19; *see also* Levine v. Frutransky, 636 F. Supp. 899, 900 (N.D. Ill. 1986) (the district court held "that plaintiffs suffered damages even though the investment portfolios incurred a net gain. Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold") (quoting Affiliated Ute Citizens v. United States*,* 406 US 128, 155 (1972) (holding that plaintiff should be awarded the difference between the "fair market value of all received and the fair value of what he would have received had there been no fraudulent conduct")); Smith v. Fahnestock & Co., Inc., No. 00 CIV. 9691, 2002 WL 334511 (S.D.N.Y. Mar. 1, 2002) (the court denied summary judgment and rejected the brokerage firm's argument that since "plaintiff's account showed an overall profit, and therefore, under the *Rolf* measure of damages, plaintiff could not recover based on losses in specific stocks."); Laney v. American Equity Inv. Life Ins. Co. 243 F.Supp.2d 1347, 1355 (M.D. Fla. 2003) (which recognized that the *Miley* and *Rolf* methods of calculating damages can be extended to cases where an investor made money).

59. Scalp & Blade, Inc. v. Advest, Inc. 309 A.D.2d 219, 232 (N.Y. App. Div. 2003).

60. *Id.* at 219-20.

61. *See id.* at 220-21.

62. *See id.* at 221-22.

by the S&P 500 index.[63] In response to the investors' allegations, the broker and brokerage firm moved for an order precluding the investors from offering proof of market adjusted damages at trial which was granted.[64] In reaching its holding, the appellate court dismissed the broker and brokerage firm's argument that the "only proper and nonspeculative measure of damages is the value of the capital actually lost by the [investors]:"[65]

> Based on the foregoing, we hold that in a case such as this, involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages is plaintiffs' "gross economic loss, adjusted for the overall market's performance". We thus conclude that the court erred in foreclosing plaintiffs as a matter of law from recovering market index or other like lost appreciation damages. Plaintiffs are not necessarily limited to recovering the value of their lost capital, and might well recover compensatory damages calculated in part on the basis of general market performance. Plaintiffs have alleged a necessary predicate for such recovery, namely, a breach of fiduciary duty extending beyond mere negligent retention of the portfolio's holdings and violation of a duty to sell or diversify. Indeed, plaintiffs have alleged deliberate and flagrant self-dealing and dishonesty on the part of defendants, namely, their unauthorized trading of the fund and speculative and otherwise unsuitable investment decisions with regard to it, transactions allegedly engaged in for defendants' own benefit. To employ the metaphor used in *Miley*, the "spilt milk" of defendants' alleged overtrading and inappropriate investment of the fund may include both plaintiffs' lost capital and plaintiffs' lost opportunity to realize generalized market appreciation or gain.[66]

## V. PRACTICAL APPLICATION

Consistent with FINRA guidance and the law, arbitration panels have recognized and awarded market adjusted damages in asset allocation cases as

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63. *See id.*

64. *Id.* at 219-20, 222.

65. *Scalp & Blade, Inc.*, 309 A.D.2d at 222.

66. *Id.* at 220, 232 (citations omitted).

well as product cases.[67]

Prior to filing a Statement of Claim, it is useful to have a profit and loss analysis prepared which includes market adjusted comparisons (*i.e.,* appropriate asset allocation percentages modeled to determine how a properly managed account would have performed). Broad indices as proxies for both fixed income and equities might include the Barclays Aggregate Bond Index, Vanguard Total Bond Fund and the S&P500 Index. This provides the practitioner with an understanding of damages and damage defenses that a brokerage firm might plead in an answer. By incorporating the damage analysis into the Statement of Claim it alerts the brokerage firm that the claimant will be seeking market adjusted damages at the hearing.

Additionally, it is imperative to propound relevant document requests during the discovery phase of the arbitration. This allows the practitioner the opportunity to adjust the initial profit and loss analysis upon receipt of further responsive models and other documents. By way of example, the following categories of documents should be requested:

1. All income and/or growth asset allocation models prepared or used by Respondent;
2. All conservative, moderate and speculative investment asset allocation models prepared or used by Respondent;
3. All documents which mention relate or pertain to how the Investment at Issue or investment strategy was marketed to Claimants;
4. All documents which concern the suitability of securities purchased on Claimants' behalf by Respondent; and
5. All documents which concern any research of securities undertaken in connection with any transaction in the Accounts.

In presenting market adjusted damages at the arbitration hearing, courts have recognized that expert opinions on market adjusted damages help to reduce speculation:

> [The expert's] approach ... was one of fiscally sound, conservative, active management of the trust estate. His alternative to the Bank's investment in [a concentrated stock position] was to concentrate the assets in the Standard and Poor's 500 index and in fixed income treasury bills. Although the Bank argues strenuously that [the expert's] approach was speculative and mere hindsight, the trial court had substantial evidence upon which to base its conclusion

67. It is important to note than many FINRA panels do not describe the award as market adjusted damages. Rather, the awards reflect a compensatory damage amount in excess of net out of pocket damages but based on a market adjusted calculation.

> that [the expert's] approach was a responsible investment alternative to the Bank's management method.[68]

It is important to explain to the panel that market adjusted damages are based on historical data (*i.e.,* benchmarks) and therefore are not the product of speculation or guesswork.

Asset allocation cases that have awarded market adjusted damages typically involve an over concentration in equities which was inconsistent with the client's risk tolerance and investment objectives. By way of example, in the case of an elderly client who had conservative investment objectives which included principal protection and a need for income, an 80% fixed income/cash and 20% equities allocation might be appropriate to evidence what the portfolio should have earned over the same time period.

Product cases that have awarded market adjusted damages have included a security that Citigroup sold to its clients as a fixed income alternative that would generate tax-free returns between 6-9%. In truth, the security was high risk and speculative. In their presentation to clients, Citigroup brokers failed to disclose, *inter alia*, the high risk and speculative nature of the security to its clients, continued to misrepresent the product and continued to mismanage the security until its implosion in 2008. Again, since Citigroup represented the security as a fixed income alternative, a 100% fixed income proxy was a consistent bench mark to establish market adjusted damages.

## VI. CONCLUSION

In conclusion, market adjusted damages are an accurate and fair measure of compensation that appropriately reflects the harm caused to the investor adjusted for actual market performance.

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68. First Alabama Bank of Huntsville v. Spragins, 515 So.2d 962, 966 (Ala. 1987) (market adjusted damages are "the amount of the loss [calculated] by weighing the actual value of the trust principal against what the value would have been had it been prudently managed." *Id.* at 964); *see also* McCoy v. Goldberg, [1992-1993] Fed. Sec. L. Rep. (CCH) ¶97,314 (S.D.N.Y. 1993) (on claim of breach of fiduciary duty, the court allowed recovery of interest the investor would have earned on "risk-free" investment in Treasury bonds in addition to losses incurred in purchase of units of limited partnerships).