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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Hot Tips Turned Flops: Liability for Unsuitable Investment Advice – An Integrated Approach

by **Hanns A. Abele**, **Georg E. Kodek** and **Guido K. Schaefer**

Abstract: This paper develops a new analytical framework for assessing losses from unsuitable investment advice, integrating both legal and economic aspects. First, a core of legal concepts for assessing losses is identified that is common to most jurisdictions. These include negligence in advice, causation as examined by the but-for-test, and the loss caused by the unsuitable advice.

Building upon these legal concepts, five economic tests are developed for analyzing the causal chain from improper advice to financial loss. If the tests show that the advice was unsuitable, the investor did not know about it, the investment violated his risk patterns, and the assets most likely chosen with suitable advice would have performed better, an economic proof for establishing liability is provided, thus supporting legal assessments of losses. Several new analytical tools are suggested to substantiate the analysis.

As a major conclusion, it is shown that proving liability for unsuitable investment advice gets more difficult, the more financially sophisticated an investor is.

– 3.7.6 A gradually rising threshold for proving losses. – 4. Summary and Conclusions.

1. Because most households have very little financial knowledge[1], they often rely on advisors for guidance on financial decisions. Unsuitable advice can wreak financial havoc on investors as recent economic crises have amply demonstrated. When investments go awry, the question arises whether financial advisors are to be held liable. A large legal literature examines this topic[2], but economic research has studied related questions only without addressing the issue upfront.[3] Hence legal analyses of unsuitable investment advice lack a solid economic framework for complex questio
establishing liability, the causal influence of the advisor, or the quantific
revolving around the tricky economic issue of how the investor would ha

This paper suggests one approach to fill the gap in the existing litera
framework for assessing losses from unsuitable investment advice.[4]
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liability is provided, thus informing legal assessments of losses. Comparing the hypothetical performance to the actual performance provides an estimate for the amount lost.

It is shown that the threshold for proving prejudice rises gradually as the financial sophistication of an investor increases. Because sophisticated investors have broader financial knowledge and more experience with risky assets, unsuitable advice is less likely to have caused them losses. Also, the analytical tools for assessing the establishment of liability and the quantification of losses must account for the heterogeneity in financial sophistication. For unsophisticated investors, normative assessments of the suitability of advice are fundamental, whereas for sophisticated investors, positive analyses of actual investment behavior matter. The five tests developed in the paper account for these differences and demonstrate how economic analysis can support legal assessments of losses.

2. An investor may have claims against several persons or entities under a wide range of possible theories. While actions may be based on suitability, negligence, negligent misstatement, failure to adhere to rules and regulations governing the securities industry, or breach of fiduciary duty, the legal analysis in this paper focuses on losses from unsuitable investment advice. In particular, emphasis will be placed on aspects raising economic questions as analyzed later in the paper.

Claims for losses from unsuitable investment advice are becoming more and more common in many countries. While of course there are many differences in detail, at a very abstract level liability for unsuitable investment advice requires four prerequisites to be met: (i) the investor has to have suffered a loss; (ii) the loss has to be caused by the advisor; (iii) the advisor violated a duty of care. Often there is an additional prerequisite relating to the advisor's state of mind, that is, (iv) that the advisor acted “scienter”[5] , or some other subjective element. Sometimes the order of these elements is reversed. Thus, the elements of the tort of negligence are often described as (i) the negligent act, (ii) causation, and (iii) a loss. However, this difference in approach does not substantially affect the analysis. All of these elements may turn out to be problematic in specific cases. Even the first element, namely that the investor has suffered a loss, although it seems pretty much straightforward, may present difficulties both as to the question of liability and as to the quantum.

2.1 Causation[6] is established by showing a link between the defendant's negligent act and the plaintiff's loss. The causation requirement is traditionally determined by way of the “but for”-test. [7] This aspect is usually described as transaction causation or cause in fact. Under this approach, a plaintiff has to show that he would not have entered into the relevant transaction or would not have entered into it on the terms he did.[8] However, once negligence is established, courts often are prone to resolve doubts about causation, within reason, in the plaintiff's favor.[9]

Obviously, the questions of whether the investor has suffered a loss and whether this loss was caused by the defendant are very closely, and sometimes inextricably, linked. This is particularly true if the investor claims damages for loss of opportunities, that is, for hypothetical investments he had made but for the unsuitable advice rendered by the defendant. In this case, the plaintiff has to prove that he would have made certain other investments if he had not received unsuitable advice from the defendant. The question of alternative investments poses significant difficulties on the factual level, that is, what alternative investments had the investor chosen in lieu of the unsuitable investment recommended by the defendant.

Even if the defendant caused a certain investment decision on part of plaintiff, this in and by itself is not sufficient to trigger liability. Rather, the defendant is only liable if he violated a duty of care.[10] Although this probably is true for all legal systems, the advisor's duties are most clearly expressed by the German concept of "*anlegergerechte*" and "*anlagegerechte* Beratung"[11], that is, advice suitable for the particular investor and for the particular investment. This approach, however, is by no means limited to civil law countries. Under US law, for example, to prove that a broker's investment recommendations were unsuitable[12], a customer must show that the broker recommended or effected transactions that were unsuitable in light of the customer's unique characteristics, including knowledge, financial situation, needs, investment experience, and account objectives, and made material misrepresentations with respect to the suitability of his or her investment recommendations, omitted to disclose that such recommendations were unsuitable where a duty to do so existed, or exercised control over the account. While this test relates to the suitability of the investment for a particular investor, the advisor can also be liable if the recommendation was not suitable for any investor, regardless of the investor's wealth, willingness to bear risk, age, or other individual characteristics.

An investor's expertise may be relevant on several levels: It may play a part in the determination of causation, that is, whether his decision was in fact caused by the unsuitable advice. Furthermore, the investor's expertise may be relevant for the determination of whether – but for the unsuitable advice he had obtained – he had sought advice elsewhere, whether he had followed that advice, and what, if any, alternative investments he had made. Also, an investor's level of expertise of course is important for whether and to what extent he needs certain issues to be explained. Thus, it is generally accepted that the specific nature of the duty of care of an investment advisor will vary, depending on the relationship between the investment advisor and the investor; hence specific facts are needed to assess what duty is owed under what circumstances.[13] For example, where the investor is uneducated with regard to financial matters, the investment advisor must define the potential risks of a particular transaction carefully and cautiously. Conversely, where an investor fully understands the dynamics of the stock market or is personally familiar with a security, the investment advisor's explanation of such risks may be merely perfunctory. Thus, the investor's expertise is relevant both for questions of liability as such and for the determination of quantum.

2.2 Once the liability of the investment advisor is established, the question of quantum arises. This is one of the most difficult questions in this field. At least one court frankly admitted that the extent of liability may be arbitrary.[14] However, even if the court's task here is extremely difficult, the court has to come up with a figure.[15] Because of these difficulties, in many countries, the standards of proof are lowered. This is particularly important for civil law countries where the standard of proof tends to be higher than the common law's preponderance standard. Thus, for example, under German and Austrian law, the court can, under certain circumstances, depart from the normal standard (under which the court has to be "convinced" that something is true) and resort to an estimate.[16] Similarly, under English law (which of course applies the preponderance standard), it is well accepted that the court, in assessing damages which depend on the court's view as to what will happen in the future, or would have happened in the future if something had not happened in the past, must make an estimate as to what are the chances that a particular thing will happen or would have happened and reflect those chances, whether they are more or less than even, in the amount of damages which it awards.[17]

While in civil law countries an investor will often be able to recover lost return on investment, under the common law this will normally only be possible where liability is founded upon the breach of a contract to provide investment advice or skilled investment counseling services. Here again alternative investments come into play. Thus, the investment the investor had made "but for" the bad advice is important not only for the loss of principal but may become relevant also for the determination of lost returns.

Obviously, this paper cannot examine the complex legal requirements of liability for all legal systems in detail. Rather, the aim is to show how closely legal and economic concepts are connected in this case. In order to demonstrate this, reference is made to legal concepts from several countries. This is for purposes of demonstration only and does not aim to provide a full-fledged comparative legal analysis. Rather, it will be shown that economic concepts are compatible with, and indeed, although maybe often in a somewhat intuitive way, lie behind legal concepts of liability for unsuitable investment advice.

3. Proving and Quantifying Losses from Unsuitable Investment Advice.

3.1 The economic analysis of damages builds upon a basic model of the investment process relating information provided by advisors and other sources to investment decisions and portfolio outcomes. Each stage in this process corresponds to a test assessing the hypothetical course of events but for suitable advice.

The advisor is likely to be liable

- if the financial advice was unsuitable for the investor

→ 1. *Financial sophistication test* 2. *Suitability-of-advice test*;

- if the investor was ignorant about unsuitable advice → 3. *Ignorance test*;
- if he had avoided the risk with proper advice → 4. *Risk management test*;
- and if he had rather chosen better-performing assets → 5. *Asset choice test*.

The tests suggested are not intended to replace a conventional legal analysis of damages. Instead, the various prongs of the tests are designed to shed some light on essential elements of liability. Thus, the first and second tests basically relate to the investment advisor's negligence, and tests number 3 and 4 to causation. Test number 5 addresses the difficult question of the hypothetical course of events but for the unsuitable advice to assess the existence of prejudice and the amount of losses. Some insights gained by means of test #1 may also provide insights as to whether the investor would have avoided the risk with suitable advice.

Obviously, the above-mentioned tests presuppose that the investor suffered a loss.[18] While in some cases it may well be debatable what constitutes a relevant loss for this purpose (e.g., an actual financial loss or already an investment which fails to comply with the risks the investor is prepared to assume), this question need not be determined here. Rather, the present analysis can be employed regardless of the kind of loss or prejudice suffered by the investor.

3.2 The financial sophistication test identifies the investor's general ability to take sound financial decisions. Sophisticated investors are more likely to be held responsible for losses than less sophisticated investors.

Financial sophistication is a complex concept with multiple dimensions.[19] The assessment can either be made in an informal manner relying upon qualitative evidence or through some quantitative approaches as suggested by existing research (e.g., see Calvet et al., 2009). The general ability of an investor for making sound investment decisions is typically related to the following factors:[20]

- financial education,
- age,
- intelligence,
- interest in financial matters,
- wealth,
- investment experience, and
- track record.

Higher age, wealth, and interest in financial matters are positively correlated with financial sophistication. Education, intelligence, and experience have a direct bearing on it. The track record reveals how skillful the investor was at managing his financial affairs. Evidence from these sources can be combined to arrive at a comprehensive assessment of financial sophistication.

A major share of the population is financially unsophisticated. Such people lack financial education and relevant investment experience. Their past portfolios included only low risk assets. These investors at the fringe of capital markets are not hard to spot but are highly dependent upon advice. Therefore, advisors have a special responsibility to counsel them with care.

Financially sophisticated investors choose assets more independently. Therefore, proving causality is harder because one must isolate the relative contributions of investors and advisors to the actual investment outcome as examined in the following tests.

3.3 The suitability-of-advice test examines whether an investor received suitable advice. The analysis focuses on the risk factors triggering the losses. Unsuitable advice is required for the liability of the investor. This is probably the key factor in investment advice. [21]

The suitability-of-advice test is rooted in portfolio and household finance research. The aims and the scope of the test are different, however. Portfolio theory and household finance aim at providing general solutions to portfolio choice. The suitability-of-advice test focuses more narrowly on specific instances of unsuitable advice, identifying clearly inferior rather than optimal portfolios. This difference is fortunate because neither portfolio theory nor household finance give unequivocal, numerically exact answers to the portfolio choice problem of a retail investor. However, "generally accepted investment principles (GAIP)" capturing the robust core of these theories usually suffice to assess whether advice was adequate. Hence, more specifically, the suitability-of-advice test examines whether the advisor correctly applied generally accepted investment principles to the financial profile of an investor and provided all relevant information about the resultant investment recommendations. The final point also matters because the advisor must communicate the outcome of the portfolio selection conducted for the client in an appropriate form.

3.3.1 The concept of generally accepted investment principles was discussed in the finance literature by authoritative scholars[22], [23]. The principles are less established than the generally accepted accounting principles from which the term is borrowed. Still, they capture essential features common to superior portfolios backed by extensive research in finance. A violation of these principles constitutes clear evidence about unsuitable advice without having to resort to full-blown portfolio optimization. Generally accepted investment principles are an important supplement to existing legal rules about advisors' duties because those rules often define only formal criteria, thus remaining economically void.

While the body of generally accepted investment principles has yet to be codified, the following rules rank high:

- broad diversification of assets to achieve a better risk-return profile,
- a consideration of the covariation of returns between assets to assess risk in the context of the overall portfolio,
- lower shares of investments into risky assets for more risk averse investors,
- less portfolio risk for less knowledgeable investors,[24] and
- a preference for steady investment strategies over a frequent reshuffling of assets.

Gross violations of duty typically imply a violation of at least one of these rules, thus exposing the investor to too much risk or too high costs or both. For example, unsuitable advice is provided if

- an advisor recommends the purchase of a single security, thus overweighting the asset in the client's portfolio;
- he overloads on risky assets relative to the risk tolerance of the client and his ability to bear risk;
- the advisor neglects undesirable interactions of the recommended asset with the returns of other assets in the client's portfolio, thus creating pockets of highly correlated risks;
- he recommends the purchase of complex securities incommensurate to the financial sophistication of the investor; or if
- he recommends too frequent changes in the portfolio.

3.3.2 Sound investment advice must satisfy generally accepted investment principles as applied to an investor's financial profile. Profiles typically contain information about investment goals, investment horizons, risk tolerance, ability to bear losses, existing assets and corresponding risks, investment experience, and any additional constraints imposed by the investor upon the portfolio selection. Also, financial sophistication as analyzed in the first test is an important element. In most countries, financial profiles need to be provided in written form and have to comply with other legal rules.

Advisors may be tempted to exaggerate the willingness of the investor to take risk because they hope to use the investment profile as evidence shielding them later against possible lawsuits. Therefore, risk profiles should be cross-checked against the financial sophistication test for credibility. Information contained in the profile should be discounted if major deviations exist.

Applying principles to profiles may appear to be a complicated process. However, a broadly diversified portfolio containing risk commensurate to the risk tolerance and the financial sophistication of the investor and obeying any additional constraints will usually be acceptable. Many broadly diversified mutual funds satisfy the criteria if they constitute an appropriate share of total assets and if the advisor provided information about the premium paid for active management relative to lower cost passive funds. The specific investment philosophy of a fund is less important. Research about naïve diversification shows that spreading risks among at least a certain number of assets (usually around 20) is of paramount importance for performance. The exact weighting policies matter less because they are often plagued by a lack of robustness (see DeMiguel et al., 2009).

For investors with average risk tolerance, best practice advisors typically recommend a share of risky assets equal to 30 to 50 percent of the total portfolio (see Canner et al., 1997). Shorter investment horizons and lower financial sophistication tend to reduce the appropriate share. Note also that research about household finance suggests to under weigh high-risk assets in the risky part of the portfolio if an investor faces significant income risk that is correlated with overall economic activity (see Guiso et al., 2012).

By applying generally accepted investment principles to the financial profile of an investor, the advisor arrives at specific investment recommendations. An essential point to be considered in the suitability-of-advice test is the kind of information about these recommendations the advisor communicates to the investor. He should include all information about returns and risks of the assets relevant to his client. A misrepresentation of such features can trigger liability even if the application of the investment principles to the profile was correct. The investor might still have decided against the assets recommended if he had received proper information. Again, the emphasis lies on the risk factors causing the underperformance.

When considering the suitability of advice, a basic terminological distinction can be made. If advice was faulty because generally accepted investment principles were not correctly applied to the financial profile, the advice was "unsuitable for the investor." If the advice was faulty due to deficient information about recommended investments, the advice is termed "unsuitable for the assets recommended." This distinction matters because the assessment of damages crucially differs as will be shown in Section 3.7.[25]

3.4 Financial advice provides information to the investor. Properly provided advice must have the effect of liberating the advisor from liability. Therefore, the investor's knowledge about unsuitable advice must preclude liability. An investor knowing about the unsuitability of the advice consciously takes on risks and must also accept responsibility for losses. For an informed investor, unsuitable advice was not causal for losses. Therefore, the ignorance test addresses the question of whether the investor knew about the unsuitability of the advice.[26]

The advisor must provide advice in a form that is understandable to his client, thus accounting for his financial sophistication. Unsophisticated investors have a limited capacity to digest financial advice. Legal analysis will usually start from the assumption that unsophisticated investors did not know about the unsuitable advice.

For other investors, assessing their knowledge at the time of the investment decision poses analytical challenges because the scope for direct observation is limited. Tricky problems of asymmetric information can arise. Still, the following pieces of evidence are useful for assessing the knowledge of an investor:

- manifest information provided by the advisor such as documents handed over and explained to the investor;
- other manifest sources of information such as the financial press, subscriptions to investment newsletters, documents written by the investor, emails etc.;
- topics covered in financial education obtained by the investor;
- financial experience; and
- evidence in the financial history of the investor about an unwanted increase in risk due to a lack of information provided by the advisor.

Manifest sources of information can provide direct evidence about the knowledge of the investor. Financial education and financial experience concern key points already discussed under the financial sophistication test. The ignorance test considers their relevance more specifically for the risk leading to the loss.

A major part of the financial experience of an investor is reflected in his financial history. It contains the kinds of risk the investor managed prior to the loss-making investment. An investor cannot claim ignorance if he learned about the risk under question from past portfolios. This insight is of far-reaching importance for the legal assessment of prejudice because it implies that an investor can only claim compensation for losses concerning risks that are essentially new to him. The portfolio history reveals which kinds of risk are ineligible for compensation. This fundamental feature of the ignorance test implies that more sophisticated investors holding bigger, better diversified portfolios face a higher threshold for passing the ignorance test because they are familiar with a bigger variety of risks. Conversely, for investors with low levels of financial sophistication, the ignorance test does not pose a big hurdle.

The financial history of the investor provides valuable information about his knowledge. Therefore, when assessing the suitability of an investment, courts also consider a client's trading and investment history. If the sophistication, or lack thereof, of the plaintiff is an issue, the client's trading history will usually be admissible into evidence.[27]

If the investor truly did not know about the unsuitable advice, he took on unwanted risk. This illusion must manifest itself as a surprise increase in the ex ante risk of his portfolio until he found out about the unsuitable advice. The issue can be analyzed statistically by examining structural breaks in the development of portfolio risk across time, accounting for changes in market risk. If such a surprise increase cannot be detected, it is not credible that the investor was not aware of the risk. The reverse need not hold true. A knowledgeable investor may deliberately "produce" a structural break in his portfolio risk by investing into the assets recommended, thus turning the liability of the advisor into a "put option." A high level of financial sophistication would be required for devising this strategy, however. Such a sophisticated investor is likely to stumble upon other points in the ignorance test. The example shows that testing for a surprise increase in risk can be of great help for assessing ignorance. Results from such an analysis should not be interpreted in isolation though.

A thorough assessment of the knowledge of the investor must also account for different degrees of ignorance and unsuitable advice. It can make a big difference to whether the advisor actively tried to cajole the investor into choosing unsuitable assets or whether he simply omitted relevant information. Also the investor may have possessed some knowledge suggesting that he was offered unsuitable advice, but he may have been uncertain about it, it may have existed in latent form, he may have only partly understood the full implications of the investment, the unsuitable advice may have irritated him, etc. In such cases, the advisor and the investor may have to bear joint responsibility for the losses. The burden sharing will depend upon how actively the advisor biased his advice and how easily the investor could have reduced or avoided the losses by making further inquiries, limiting his exposure. Only more sophisticated investors are likely to be held jointly responsible though.

3.5 The risk management test examines whether the risk management of the investor would have responded to adequate advice by rejecting the loss-making asset. Any investor claiming damages asserts that he had such effective risk management in place. Risk management is understood in a very broad sense including all kinds of approaches to portfolio choice limiting risk. Had the investor still opted for the same asset, the advice would not have caused the loss.

The risk management test only addresses the question whether the investor would *not* have invested into the loss-making asset. It remains largely mute about which alternative investment the investor would have chosen. The main reason is that in many cases clear-cut answers can be provided to the first question by considering inconsistencies with existing risk management. However, precise answers are hard to come by for the second question focusing more on specific characteristics of assets. The asset choice test in the next section deals with these issues in depth.

Explicit risk management needs to be distinguished from implicit risk management for the assessment of damages. Explicit risk management is helpful because it allows simulating whether using proper advice as an input into the risk management process would have resulted in a rejection of the loss-making asset. Implicit risk management can only be inferred from past portfolio patterns. Due to the need for indirect reasoning, the conclusions tend to be less robust than for explicit risk management.

3.5.1 Explicit risk management is characterized by a structured process limiting portfolio risk depending upon the information provided by the advisor. Prime examples are investment algorithms or explicit risk criteria imposed by the investor such as in his financial profile. If an investment algorithm exists, one can simply feed the algorithm with the data from proper advice and observe whether the investment decision is changed. For retail investors such an algorithm is unlikely to be available. Their most important form of explicit risk management is the definition of risk limits in the financial profile. As discussed in Section 3.3.2, the financial profile includes explicit provisions about the risk tolerance of the investor, investment goals, or other asset criteria imposed by him. All these elements serve to narrow down the range of assets deemed acceptable from a risk perspective. Only assets fulfilling these risk criteria are suitable for the investor.

If an advisor violated the risk criteria explicitly imposed by the investor and recommended assets unsuitable for him, the risk management test can be conducted easily. Had the advisor recommended assets adequate to the investor, it is highly unlikely that the investor would still have selected the loss-making assets from the large universe of possible assets against proper advice and his own stated intentions. Hence, it is practically certain that with proper advice, the investor would not have invested into the bad assets actually chosen. As a major conclusion, the risk management test will virtually never pose a hurdle if the advice was unsuitable for the investor.

3.5.2 In some cases, the analysis of explicit risk management criteria as included in the financial profile of the investor remains inconclusive. This may happen, for example, because the criteria were only loosely defined. Also, doubts may exist whether the document was distorted by the advisor towards higher risk as discussed in Section 3.3.2. The financial profile can be inconsistent, containing contradictory criteria. Particularly relevant is the case in which the advice was suitable for the investor, but unsuitable for the asset. Thus, the advice did not openly contradict the financial profile and generally accepted investment principles, but still the advisor failed to inform the investor about the relevant risk and return features leading to the losses. It is possible that the investor would still have decided against the assets recommended by the advisor if he had been properly informed.

In case there are no explicitly stated risk management criteria, one has to examine whether sufficiently stable risk patterns can be inferred implicitly from the portfolio history of the investor. If in the past the investor always adhered to certain risk principles, it is unlikely that he would have chosen assets inconsistent with these principles when obtaining proper information about them.

The reliable identification of risk patterns may be a tedious task. Yet, several analytical tools can be applied to this analysis. The clearest indirect evidence can be obtained if due to the unsuitable advice the ex ante portfolio risk of the investor significantly exceeded its global maximum in the entire portfolio history. If sufficient data is available, a statistical analysis of structural breaks can be conducted analogous to the ignorance test in Section 3.4.

A tricky issue to decide is which risk measure captures best the portfolio risk managed by the investor. Standard measures used in finance such as value at risk or the standard deviation of returns may be too difficult to obtain and interpret for a retail investor. Portfolio shares of certain asset classes or other more rudimentary measures may serve as a proxy capturing better actual portfolio behavior. Given a set of candidate risk measures obtained from this analysis, one can test statistically for structural breaks.

More often, retail portfolios will be either erratic or rather inertial, with infrequent transactions. Even if a lack of data rules out statistical analysis, informal examinations of stable behavioral portfolio patterns can still be meaningful and informative about risk limits followed by the investor. Erratic behavior is analytically harder to deal with than portfolio inertia. Section 3.7.4 will discuss this type of investors.

Violations of global risk maxima capture only gross instances of unsuitable advice. They have the benefit of being easily detectable in the data. However, it is possible that in less extreme cases the investor was still misinformed and would have decided against the asset with proper information even though global risk limits were not violated. Note that in these cases, recommendations are adequate to the investor, the size of the risk looks acceptable given past risks taken by the investor, and the actual risk management process is unobservable to outsiders. The advisor only omitted some information about the assets. In this case, the investor will have difficulty fulfilling the legal standard required for proving damages unless he can support his claim with additional, convincing evidence. Particularly, if the standard of proof is high, it will not be possible to establish with high certainty that the investor would have decided against the loss-making asset. This observation is important because it shows that cases in which the advice was unsuitable for the asset are harder to prove than cases with advice unsuitable for the investor.

A final point worth noting about the risk management test is that the same logic applied to the identification of upper risk limits may also be applied to the identification of lower risk limits. The same kind of statistical tests can also be conducted to examine minimum risk levels. This point is of particular interest for the quantification of losses discussed in the following section. Investors may argue that they would have chosen safe assets but for the unsuitable advice. If the analysis of minimum risk limits suggests this choice to be unlikely, only riskier, potentially worse performing assets are to be considered for calculating damages.

3.6 The asset choice test examines which assets an ill-advised, ignorant, risk managing investor would have chosen if he had received proper advice. This is in line with the ultimate goal of the law of damages to place claimant in the same position as he would have been in if he had not sustained the wrong. While clear in principle, determining the hypothetical course of events as to what would have happened if the unsuitable advice had not been given can be extremely difficult.[28] Courts will generally be willing to accommodate for these difficulties. Thus, in the common law, once the injured client puts forward sufficient proof of a fiduciary breach, the onus shifts to the investment advisor to prove the loss would have occurred regardless of the breach.

The asset choice test draws upon the preceding tests; hence, it cannot be sensibly interpreted in isolation. The asset choice test poses a formidable analytical task because both investor behavior and financial markets are very complex. Usually, there is not just one likely course of events. Therefore, exact predictions of alternative behavior with suitable advice are impossible. Fortunately, legal analysis only requires tough standards of proof for establishing liability. Once liability is established, the standards of proof are lowered and estimates for approximating the extent of compensation are permissible. This same reasoning is applied in the asset choice test here.

The first step in the asset choice test is to collect all constraints narrowing down the set of eligible alternative assets as available from the case. The following pieces of evidence can be helpful for this analysis:

- Investment criteria derived from the financial profile such as investment goals, risk tolerance, preferred categories of assets,… The appropriate benchmark has to be determined in each case, depending upon the circumstances and risk aversion of the investor;[29]
- investment categories about which the investor is knowledgeable as derived from the ignorance test;
- upper and lower boundaries on acceptable risk resulting from the risk management test;
- and preferences revealed by the asset choice with unsuitable advice: if the investor believed to acquire a medium risk asset of a certain type and was actually recommended a high risk asset, the actually desired asset may be a good approximation for the alternative choice of the investor.

These criteria reducing the set of alternative eligible assets need to be categorized further into such criteria which are highly certain and into other, less certain criteria. For proving liability, only the highly certain criteria should be considered. If (almost) all assets in this set performed better than the loss-making asset, it is highly likely that damage exists. This conclusion completes the proof for establishing liability. Note that this proof does not require an exact determination of the quantum of damages.

If a substantial share of eligible assets performed at least as badly as the loss-making asset actually chosen, a high standard of proof cannot be satisfied. For lower standards of proof, it will matter how big this share of badly performing assets was and how likely the investor was to select these assets.

If liability can be established to the requisite legal standard, less exact estimations of the quantum of damages suffice from a legal perspective. Hence, the other, less certain criteria can also be used to narrow down further the set of eligible assets. An approximation of the value of the alternative investment with proper advice is obtained by taking some average across the value of the remaining assets. For example, an index may be constructed expressing the average value of the alternative asset holdings. Thus, in a 1985 case, the court based its decision on the performance of the TSX's main index over the relevant time period.[30]

Note that it is not a hopeless task to examine whether all the eligible assets performed better than the loss-making asset actually chosen. As, typically, the unsuitable asset recommended exhibited too much risk and the investor would have actually desired to hold lower risk assets, in many cases, the lower risk assets should have performed better than the loss-making high-risk asset. Hence, in clear-cut cases of unsuitable advice, the asset choice test should yield convincing results. On the other hand, the test implies that in a general market downturn also many of the alternative assets will lose value, thus, either making the proof impossible or at least limiting the amount of compensation.

3.7 The importance of each of the five tests for proving damages varies depending upon the type of investor and the kind of unsuitable advice considered. Four distinct groups of cases emerge: (i) financially unsophisticated investors, (ii) at least moderately sophisticated investors receiving advice unsuitable for an investment, (iii) at least moderately sophisticated investors receiving advice unsuitable for the investor, and (iv) erratic investors. Each of these cases requires a closer examination.

3.7.1 The financial sophistication test reliably identifies financially unsophisticated investors because a complete lack of financial education and financial experience is clearly discernible. Due to a lack of capacity to take informed investment decisions alone, an unsophisticated investor can only follow advice or gamble. However, financially unsophisticated investors are not habitual gamblers. With financial experience from past risky investments, they would not qualify as unsophisticated. Hence, unsophisticated investors basically follow the advice provided by the advisor or hold riskless assets. This behavioral feature of unsophisticated investors also implies a clear answer to the question of how the investor would have invested with proper advice: He would most likely have followed the recommendations as he did for unsuitable advice.[31] The economic content of the adequate recommendations matters for establishing liability and quantifying the extent of losses. The asset choice test needs to be conducted from the perspective of the advisor asking what assets would have constituted adequate advice and how they would have performed. Because an unsophisticated investor would usually have been recommended lower risk assets, the establishment of liability should be clear in most cases.

As a conclusion, for financially unsophisticated investors, the analysis of prejudice focuses on the normative question whether the investor received adequate advice. The financial sophistication test and the suitability- of-advice test particularly matter. The asset choice test needs to be conducted from the normative perspective of adequate advice. The ignorance test does not pose a hurdle because unsophisticated investors are unlikely to be aware of unsuitable advice. The risk management test is also satisfied because unsophisticated investors largely delegate risk management to the advisor.

3.7.2 If an investor received advice consistent with his financial profile and with generally accepted investment principles, but was not properly informed about the relevant risk and return features of the asset leading to the loss, he received advice unsuitable for the asset. Investors have to be at least moderately financially sophisticated because otherwise they belong to the category analyzed in the preceding subsection.

The establishment of liability due to advice unsuitable for assets requires a thorough consideration of all five subtests. The main hurdles are posed by the ignorance and the risk management test. The more sophisticated an investor, the harder he will find it to prove that he did not know about the risk leading to the loss. Also, clear portfolio patterns must be identifiable in the portfolio history of the investor contradicting an investment into the loss-making asset. Again, risk-taking and fluctuations in portfolio values are more common for sophisticated investors. Hence, it becomes harder to show that the loss-making asset would have been rejected with suitable advice.

3.7.3. If an at least moderately sophisticated investor received advice inconsistent with his financial profile and generally accepted investment principles, the advice was unsuitable for the investor. Typically, the advice ran counter to risk constraints imposed by the investor. As discussed in Section 3.5, the risk management test becomes much simplified because such risk constraints are the most important form of explicit risk management for retail investors. Had the investor received proper advice conforming to his risk constraints, it is highly unlikely that he would still have invested into the loss-making asset.

As a conclusion, if advice was unsuitable for an investor, even a more sophisticated investor can convincingly argue that he would have avoided the loss with proper advice. The main challenge for such investors remains the ignorance test because still an investor cannot claim damages for risks he was aware of.

3.7.4. Many real-world retail investors follow suboptimal portfolio policies, moving in and out of assets.

They are driven by unsound investment strategies, dubious information, individual passion, market sentiment, sometimes following advice, and sometimes deciding against it. They can be considered erratic investors. Such investors may have a hard time proving their case even if they were ill-advised and really would have rejected the loss-making asset with suitable advice. Due to their capital market experience, they do not qualify as financially unsophisticated. They face difficulties passing the ignorance test because they were exposed to many kinds of risks in the past even if their actual learning from past losses was limited. Their lack of consistent risk management also makes it hard to pass the risk management test.

The question for the law of damages is whether such investors should go unprotected. Evil-minded advisors could spot these investors and cajole them into buying risky assets, thus generating fee income without having to fear liability claims. It may be argued that erratic investors should obtain some, though not full, compensation. Sometimes they suffer true damages because proper advice would really have guided them to better investment performance.

A critical issue to be considered with erratic investors is the standard of proof. If near certainty is required, erratic investors face a low chance of successfully making a case in traditional tort law. A lower standard of proof increases their chance, but still the hurdle remains high. Joint responsibility may apply in some cases, leading to the result that the investor obtains partial compensation. However, joint responsibility generally has special prerequisites.

An alternative concept addressing the concern about erratic investors is stochastic causation. Stochastic causation applies if losses were caused to members of a group with some probability. However, whose loss was due to the damaging source under question and who suffered losses from other sources cannot be identified. The solution is to pay damages to each member of the group, but only proportional to the probability of having been affected. Stochastic causation addresses the problem of awarding compensation in complex cases with lots of uncertainty. Still, it may pose major conceptual challenges for traditional law.

The analogy carrying over to erratic investors is that in a certain percentage of cases the investor would have truly followed the better advice and thus avoided losses. It only remains unclear how in the case under question the investor would have decided due to his inherently stochastic behavior. Again, the investor would receive only part compensation for losses. It may be a tricky task to assess the probability that a given investor would have followed suitable advice to determine his due share. Still, the concept of stochastic causation deserves more consideration in the discussion about damages for unsuitable investment advice. It may provide a solution to the problem that an important group of investors miss out on compensation they should actually receive.

3.7.5. Summing up all subcases considered so far, a testing scheme emerges from the analysis. Financial sophistication (test 1) and suitability of advice (test 2) always need to be examined. If advice was unsuitable and the investor's financial sophistication is low, the advisor is likely to be liable and the quantum is determined by looking at suitable recommendations. For at least moderately financially sophisticated investors, their ignorance about the risk leading to the loss always has to be examined (test 3). Furthermore, if the advice was unsuitable to the at least moderately sophisticated investor, the risk management test (test 4) usually will be passed and one can proceed directly to the asset choice test (test 5). If the advice was unsuitable to the asset into which an at least moderately financially sophisticated investor had invested, all five tests need to be conducted to assess damages.

Each of the tests is supported by a set of analytical tools as developed in the preceding sections which mostly rely upon generally available information. Hence, the tests can be readily applied in practical cases.

3.7.6 The analysis above suggests that the correct determination of the degree of an investor's financial sophistication is critical for assessing liability. However, it should be noted that the threshold for proving damages rises only gradually. A moderately sophisticated investor will not find it much harder than the unsophisticated investor to prove his case. It will be credible that he did not know about the unsuitability of advice. Undesired high risk will pop out from a smallish portfolio of moderately risky assets.

At the other end of the spectrum, highly sophisticated investors face a lower chance of successfully claiming damages. They will find it hard to prove their ignorance and to prove for a broadly diversified portfolio including high-risk assets that they would not have invested into the loss-making asset but for proper advice. Only if the risk was quite esoteric and if the investment explicitly contradicted their risk management, it may be convincing that they suffered damages.

4. Integrating concepts from law and economics, the paper aims at developing an applicable approach for a better handling of liability. First, important legal dimensions are spelled out. Then, five economic tests are developed to assess the suitability of advice, causation, and the foundation as well as the amount of losses. The tests examine each stage in the chain of events from unsuitable advice to underperformance. The motivation for the tests is derived from law, their intellectual foundation draws upon economic research, and their design is chosen with an eye on practical applicability. The tests are supported by a set of analytical tools developed in this paper to meet specific legal needs.

To provide a better economic foundation for legal assessments of liability for unsuitable investment advice, the tests suggest to

- assess suitability based upon generally accepted investment principles,
- assess the ignorance of the investor by looking at surprise increases in his portfolio risk,
- assess portfolio behavior by looking at inconsistencies between risk management principles followed by the investor and the assets recommended,
- assess asset choice with suitable advice by focusing on the most likely investment alternatives and building an index to gauge performance.

As a major conclusion, the paper emphasizes the role of the financial sophistication of an investor for determining liability. Financial sophistication marks the line between the responsibility of advisors and investors. The more sophisticated an investor, the less likely he is to pass all tests and to claim liability successfully. It also matters whether the advice was unsuitable for the investor or for the asset recommended, as the latter is harder to prove. Most protection is granted to unsophisticated investors. The paper takes an intermediate position in the discussion about liability for unsuitable investment advice, holding advisors and investors accountable depending upon their relative influence on the investment outcome.

Some questions alluded at in this paper, however, need further research, such as a more detailed analyses of past portfolio patterns, issues of asymmetric information complicating the proof of losses, the codification of generally accepted investment principles, or the adaptation of the framework to specific jurisdictions and cases. These issues at the intersection of law and economics need more thorough discussion which is beyond the scope of this paper.

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[1] See Lusardi and Mitchell (2011), (2013) for an overview on the international evidence about financial literacy. However, public awareness of the lack of financial affairs has grown as well and have led to increased efforts to remedy the situation; see Grifoni and Messy (2012) for OECD, or President's Advisory Council on Financial Capability (2012) for the US, or Romagnoli and Trifilidis (2013). The number of policies and/or empirically oriented contributions are increasing.

[2] For the United States, see, for example, Parker, Stockbroker Litigation, American Jurisprudence. Trials. Database (updated April 2011); for Canada, see Clarke, Liability and Damages in Unsuitable Investment Advice Cases (2005), http://www.investorvoice.ca/Research/LIABILITY_AND_DAMAGES.pdf; for the United Kingdom, see Conaglen, Equitable compensation for breach of fiduciary dealing rules, 2003 Law Quarterly Review 246; Poole, Reforming damages for misrepresentation: The case for coherent aims and principles, Journal of Business Law 2007, 269; Ryan & Young, Springwell – Are the English Courts the venue of last resort for complex investor claims? 2009 Journal of International Banking Law and Regulation 2009, 24 (1), 54; Thorsen, Kaplan & Hakala, Rediscovering the Economics of Loss Causation, 6 Journal of Business and Securities Law 93 (April 2006), for Germany Wagner, Schadensberechnung im Kapitalmarktrecht (The determination of quantum in capital market law), ZGR 2008, 495, for Austria Kock, Liability for unsuitable advice on investment funds (Austria), Journal of International Banking Law and Regulation 2011, 26 (9), 461; Kodek, Ausgewählte Fragen der Schadenshöhe bei Anlegerschäden (Selected questions of quantum in investor damages cases), ÖBA 2012, 11; Leupold & Ramharter, Anlegerschaden und Kausalitätsbeweis bei risikoträchtiger hypothetischer Alternativanlage (Investor damages and proof of causation in case of high-risk hypothetical alternative investments), ÖBA 2010, 718.

[3] The household finance literature as surveyed by Campbell (2006) and Guiso and Sodini (2012) provides very useful positive and normative analyses of households' investment behavior. Research on financial advice focuses on the agency problem between financial advisors and individual investors. See the survey by Inderst and Ottaviani (2012); theoretical work by Bolton, Freixas, and Shapiro (2007) and

Krausz and Paroush (2002); or empirical studies by Hackethal et al. (2009 and 2010).

[4] It goes without saying that the analysis has to concentrate on a small issue to achieve results. Quite a lot of interesting questions such as dynamics of investment, time horizons, asymmetric information, etc. have to be neglected; for introductions to these issues, see Cesari and Cremonini, (2003), Gaivoronskia and Stellab, F. (2003), Blomvall and Lindberg (2003), Agnew and Szykman (2005).

[5] This is the case in the United States under SEC Rule 10b-5. See, e.g., *Dura Pharmaceuticals v Broudo*, 344 US 336 (2005), at 341.

[6] In spite of the paramount importance of the concept of causation, there is surprisingly little legal authority on the question of causation. See Rt Hon Lord Hoffmann, "Common Sense and Causing Loss", unpublished lecture delivered to the Chancery Bar Association, June 15, 1999, noting that the numerous judicial citations of "common sense" in relation to "causation" often "conceal, or perhaps reveal, a complete absence of any form of reasoning" in the best tradition of English anti-intellectualism. See also *Fairchild v Glenhaven Funeral Services Ltd* [2003] 1 A.C. 32 at [53].

[7] See, e.g., *Barnett v Chelsea & Kensington Hospital* [1969] 1 QB 428.

[8] *Bristol v West Building* [1998] Ch 1.

[9] *Kwasny v United States*, 823 F2d 194 (7th Cir 1987).

[10] For purposes of this paper it is not necessary to distinguish between contractual and fiduciary duties in this respect since this distinction is irrelevant for the underlying economic questions.

[11] See, for example, German Federal Supreme Court NJW 1993, 2433.

[12] FINRA Rule 2310 requires the representative to only make suitable recommendations and to deal fairly with customers.

[13] For a discussion of the concept of fiduciary duty in this context from a perspective of Canadian law, see Clarke, Liability and Damages in Unsuitable Investment Advice Cases (2005) 32 et seq. However, the elements discussed by Clarke are relevant for the determination of the nature and scope of duties of care under civil law as well.

[14] See, for example, the Canadian case of *Secord v Global Securities Corp.* (2000) 8 BLR (3rd) 238 (B.C.S.C.).

[15] Clarke, Liability and Damages in Unsuitable Investment Advice Cases (2005) 76.

[16] Section 286 German Code of Civil Procedure, section 273 Austrian Code of Civil Procedure.

[17] See, e.g., *Mallett v McMonagle* [1970] AC 166, 176.

[18] Historically, so few cases have gone to trial that no well-developed case law regarding the proof of loss exists. Nearly all of the case law regarding loss has arisen in the context of motions to dismiss summary judgment, class certification, evidentiary battles, or settlement. Thorsen, Kaplan & Hakala 2006, at 113.

[19] Financial literacy is a closely related concept that many researchers have scrutinized in recent years. See, for example, Lusardi and Mitchell, 2011, 2013. Apart from literacy, financial sophistication also emphasizes the practical side of investing, thus directing attention to actual investment performance; see i. a. Jacobs, e.a. (2010), Kelley and Tetlock (2013).

[20] Some (but not all) of these factors are recognized in the US Financial Industry Regulation Authority's Rule 2111 on 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."

[21] See, for example, *Rule 2111 (Suitability)*of the US Financial Industry Regulatory Authority (FINRA) (quoted in footnote 19).

[22] Optimal portfolio choice is a classical problem studied in financial economics. See Elton and Gruber (1997) for a survey. For a more recent account of optimal portfolio choice see Brandt (2010). The newly emerging literature on household finance argues that the classical approach only partly applies to households' financial decision-making. See footnote 2 for references.

[23] See Bodie and Crane (1997) for a list of generally accepted investment principles.

[24] See Gorton and Penacchi (1990).

[25] For a similar distinction between "anlegergerechte" und "anlagegerechte Beratung" (advice suitable for the investor and advice suitable for the product) in German law, see supra 2.1.

[26] For the sake of completeness, it should be mentioned that the knowledge of the investor may also be relevant for other questions, for example, for questions of comparative negligence or for determining when the investor should have found out about the unsuitability of the advice and, consequently, should have taken steps to mitigate the damage. See, for example, Laflamme v. Prudential-Bache Commodities Canada Ltd., [2000] 1 S.C.R. 638: "In the case of injury resulting from mismanagement of a securities portfolio, a flexible approach must be taken in determining what constitutes a reasonable period of time for the client to act and mitigate the damages. In particular, regard must be had to the client's level of experience and knowledge of investments, and to the complexity of the situation."

[27] Clarke 24.

[28] On the evidentiary gaps faced in this context, see Stapleton 2003 at 401.

[29] Clarke 66.

[30] *Ryder v Osler, Wills, Bickle Ltd* (1985). While the decision concerned ill-management of a portfolio rather than investment advice, the method employed by the court, that is, using an index for a determination of damages, can be applied to the present context as well. See also Clarke 66.

[31] In German law, there is a presumption that the investor, had he been suitably advised, would have followed that advice. See German Federal Supreme Court BGHZ 61, 118; see also Canaris, Die Vermutung aufklärungsrichtigen Verhaltens und ihre Grundlagen, in FS Hadding (2004) 3 f . This presumption, however, may not reflect real life in all cases. For a case in which an investor was found not to have followed advice in any event, see *JP Morgan Bank v Springwell navigation Corp* [2008] EWHC 1186 (Comm) (QBD (Comm)); see also Ryan & Young, J.I.B.L.R. 2009, 24 (1), 54.

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