NOP Redux

The conundrum of NOP's (Net Out-Of-Pocket) in securities Arbitration is that its application has been a mishmash of rulings both supported and rejected by Claimants and Respondents alike. Over the past years of rising markets, Respondents typically claim NOP's to be the measure of damages, yet in falling markets (2008-2011), they argued for MAD (Market Adjusted Damages); Claimant's the reverse. MAD and NOPs often vary substantially, particularly if substantial time has elapsed between the losses and the Statement of Claim filing date. Finra Arbitration Panels have awarded both.

Assume a small but thriving Tee-Shirt Silk Screen company, TSSS, with an initial investment of $50,000 for equipment and materials. Over two years TSSS builds $200K in inventory, purchased $50,000 in additional silk screens, paid a 75,000 annual salary and expected to turn a $500,000 profit from World Cup licenses in 2018. Two months before the World Cup, the business manager defects to a competitor, sabotages the inventory triggering a bank foreclosure on the inventory loan permanently ending operations. Assume the Manager is fully liable and agrees to Arbitrate. What are the damages?

The Respondent says there are no damages, Claimant only invested $50,000 and took out $150,000 in salary over two years, which amounts to a net two- year profit of $100,000. This is cash basis accounting (NOP). TSSS on the other hand points to the lost Enterprise Value of the operation, the growth engine behind the business not reflected in NOPs. There is $200,000 in profits reinvested in inventory with a wholesale value of $400,000 lost and ignored by NOP and $50,000 in new equipment all internally financed. The business is scalable, low-cost and can withstand and adapt to market changes. Its capitalized risk-adjusted return indicates an Enterprise value of 2 X EBIDTA (earnings before interest, depreciation, taxes, and amortization) of $600k. Clearly NOPs are not a measure of damages for TSSS in commercial arbitration, but would the outcome be the same in Finra Arbitration?

A principal concern is the treatment of reinvested profits, dividends, and distributions. NOP's make no distinction between return on and return of investment. Yet income investors specifically take on lower market risk for income with the expectation of principal stability from a growing inventory of income producing shares. Valuation of income securities is closely correlated with interest rates, not the SP 500 and growth occurs primarily through dividend reinvestment that increases the inventory of stable producing securities. Every share or unit is an engine of growth, a small enterprise that generates income and growth at identified risk. In the case of TSSS, $250,000 of profits were retained and reinvested in tangible inventory and equipment all of which is recoverable. But, if TSSS invested in an income portfolio instead of silk screens and inventory and reinvested $250,000 in additional shares (DRIPS, dividend

reinvestment plans), that $250,000 reinvestment is ignored by NOP and excluded from recovery. A case I am working on should illustrate NOP issues.

Claimants are 6 participants in a $1.5 million pension plan advised by Broker who sets up all accounts primarily for income. Over 8 years the portfolios, 90% C shares, generated $450,000 in dividends all of which was reinvested in additional shares. The Broker then liquidated $450,000 of shares and put them into bad reits and Ponzi offerings effectively losing 8 years of accumulated shares ignored by NOP. Still the overall performance was barely profitable, about 1%/yr. As is evident, there is a huge disparity between NOP and MAD, especially over an 8-year span.

NOP is also a net number, and netting of profits and losses, (if accurately reported) may be inappropriate in cases where defined abuses impair portfolio growth. Traditional account analyses provide two forms of analysis, a reconciliation of the cashflows and a trading account analysis. Both are expected to prove up the NOP and match. The trading P&L plus interest and dividends, less fees and margin should equal the Statement NOP. Both calculations ignore the destruction of a functioning portfolio set up to reinvest and grow organically through share accumulation over several years.

In growth portfolios income may be de-minimis, but income portfolios grow through compounding, reinvesting over time to build the portfolio. In portfolios invested primarily for income, DRIPs accurately measure portfolio return and provide a measure of damages independent of NOP or MAD. In my case, an analysis run only on the $450,000 DRIP cash flow over eight years using a 50/50 allocation grew to over $800,000, illustrating what the account value would have grown by in the absence of the NCI's and their $450,000 trading loss. Can squandering 95% of the accumulated income-producing shares be inoculated from liability by a 1/yr.% overall portfolio profit? If all you review are the NOP confirmation balances, then you ignore any destructive trading activity that specifically diminished returns, and effectively agree to netting losses with gains.

Next, consider that most NCI investments were originally carried at cost and transfers between accounts or out of a portfolio were frequently also reported at cost. NCIs substantially change portfolio risk and liquidity, impair credit, and increase costs. Many older account statements overstate NCI values for months if not years making retroactive adjustments nearly impossible. It also means that the ratios for turnover, fee%, costs, and NOP could be incorrect if based solely upon the statements. If the account analyst properly adjusts for true NCI's value, losses will increase, and trading activity no longer will confirm NOP. In my case, unit prices were retroactively adjusted from $10/sh to $4.00/sh resulting in an additional $250,000 loss not reported in the statements.

Fees and charges reduce return in two ways, 1) they reduce current returns annually, and 2) they reduce the number of shares added to the portfolio permanently impairing future compound growth under a DRIP. Assuming a $1million investment in mutual fund "C" shares paying a 1% 12b fee, over twenty years it will cost approximately $550,000 of which $390,000 is fees and $160,000 is lost appreciation with average 6% yearly growth. Whether 12b fees on C shares, variable annuity charges, or excess management fees, the impact over time can be substantial even if the portfolio is properly allocated, profitable and suitable.

Claims based on recovery of fees and charges are entirely independent of market performance or portfolio allocation. NTM 03-47 confirms that "Refunds should be made regardless of the performance of the mutual fund purchased by the customer" with interest. Damages are calculable, unrelated to NOP, and should never be conflated with general suitability claims. In my case, excess fees with interest computed to over $90,000.

Class Settlements present another problem for account analysis. If an investor settles in a class action, the impact of those investments in the analysis should be adjusted to reflect actual value or eliminated entirely. In the recent case alluded to above, the claimants held $200,000 in Shale and Medcap investments that were never marked to market. The claimants accepted the class settlement for both and Medcap and Shale were removed from the matched trades analysis including all DRIPs, (dividend reinvestment program). Shale and Medcap values and income remained on the Statements at cost however, and analyses based on them should be adjusted for the class settlement.

Many of the claims I see focus on the suitability of NCI's, the low hanging fruit, to the exclusion of a thorough trading analysis that traces funds, provides support, and identifies potential independent claims such as for fees and costs, fund switching, variable annuities charges and disgorgement. None of those claims are market-based or subject to suitability defenses but are about the impairment of returns through excessive costs and fees, not NOP.

Finally, when reinvested income is a substantial driver of portfolio growth it should always retain its character as income. NOP treats all distributions as principal first when in fact investors believe distributions are income and are taxed as income, and are actually advised to spend them as income. Then, as is common in arbitration after years of living on "income" distributions, the investor first hears that he only "got his money back". As for undistributed and reinvested dividend contributions, those are simply ignored by NOP all of which raises the question, "where's the income?"

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