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# A REVIEW OF THE GAO REPORT ON THE SALE OF FINANCIAL PRODUCTS TO MILITARY PERSONNEL

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINATION OF A GOVERNMENT ACCOUNTABILITY OFFICE REPORT ON THE SALE OF FINANCIAL PRODUCTS TO MILITARY PERSONNEL, FOCUSING ON ACTIONS NEEDED TO PROTECT MILITARY MEMBERS

NOVEMBER 17, 2005

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# C O N T E N T S

## THURSDAY, NOVEMBER 17, 2005


| | Page |
|---|---|
| Opening statement of Chairman Shelby | 1 |
| Opening statements, comments, or prepared statements of: | |
| Senator Sarbanes | 2 |
| Senator Enzi | 4 |
| Senator Schumer | 5 |
| Senator Bunning | 6 |
| Senator Dole | 7 |
| Senator Allard | 8 |


## WITNESSES


| | |
|---|---|
| Richard J. Hillman, Managing Director, Financial Markets and Community Investment, U.S. Government Accountability Office; accompanied by Cody J. Goebel And Jack Edwards | 9 |
| Prepared statement | 37 |
| John M. Molino, Deputy Under Secretary of Defense for Military Community and Family Policy, U.S. Department of Defense | 22 |
| Prepared statement | 62 |
| Lori Richards, Director, Office of Compliance, Inspections, and Examinations, U.S. Securities and Exchange Commission | 23 |
| Prepared statement | 67 |
| Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, National Association of Securities Dealers | 25 |
| Prepared statement | 73 |
| Response to written questions of Senator Sarbanes | 81 |
| John Oxendine, Commissioner of Insurance, State of Georgia | 27 |
| Prepared statement | 77 |
| Response to a written question of Senator Sarbanes | 84 |

# A REVIEW OF THE GAO REPORT ON THE SALE OF FINANCIAL PRODUCTS TO MILITARY PERSONNEL

**THURSDAY, NOVEMBER 17, 2005**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:06 in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning, the Committee will hold a hearing on a recently completed Government Accountability Office investigation examining the sale of financial products to our Nation's servicemen and -women. Last year, I, along with Senator Sarbanes, asked the GAO to study the regulatory oversight associated with the marketing and sale of the insurance and investment products being offered to servicemembers. We also asked the General Accounting Office to assess the range and quality of these financial products, particularly with respect to the offerings in the civilian market.

Quite simply, GAO's findings are troubling. The report makes clear that military personnel are being sold costly, outdated, and even unnecessary securities and insurance products. It also indicates that military personnel frequently are victims of deceptive and illegal sales practices.

Specifically, with respect to securities products, GAO found that a few financial service companies marketing specifically to servicemembers sell an archaic and obscure investment vehicle called a contractual plan that is characterized by an unusually high 50-percent sales charge over the first year. These sales persist notwithstanding the fact this product all but disappeared from the civilian market in the early 1980's due to excessive sales commissions.

Furthermore, financial advisers have questions whether this product is ever a suitable investment given the fact that there are hundreds of reputable no-load mutual funds available today.

With respect to insurance products, GAO identified six insurance companies that catered to the military market. According to the report, insurance agents from these companies sell expensive life insurance that is oftentimes illegally marketed as a security. They market these products to the military even though most service-

members automatically carry a low-cost, government-provided $400,000 life insurance policy that provides coverage here.

Perhaps most troubling, there is ample evidence that our men and women in uniform are routinely rushed through stacks of paperwork as part of a captive audience, unaware of what they are signing and purchasing.

The report is also quite critical of the Department of Defense's performance in regulating solicitations on military installations and sharing information with financial regulators. To discuss GAO's investigation and related issues with us this morning, we have Richard Hillman, who authored the GAO report. On the second panel we will hear from John Molino, who is the Deputy Under Secretary of Defense for Military, Community, and Family Policy; Lori Richards, who is Director of the Office of Compliance, Inspections, and Examinations, Securities and Exchange Commission; Mary Schapiro, who is the Vice Chairman of NASD; and John Oxendine, who is the Insurance and Safety Fire Commissioner for the State of Georgia.

I want to commend you, Mr. Hillman, for the excellent report and the work GAO has done here, and I look forward to everyone's testimony.

Senator Sarbanes.

**STATEMENT OF SENATOR PAUL S. SARBANES**

Senator SARBANES. Thank you very much, Mr. Chairman, for calling this hearing and for joining in asking for the GAO study. We will hear their report this morning on the sale of financial products to members of our armed forces. Regrettably, abuses in this area have been widely reported. *The New York Times1* published a series of articles on this subject last year. In September 2004, you and I asked GAO to conduct a study of these problems, and we will hear their analysis and then the comments by relevant regulators here this morning. I would like to also acknowledge the efforts of Senator Enzi on this issue. I know he has taken a very keen interest in it.

Chairman SHELBY. Very much.

Senator SARBANES. And he has introduced legislation on the subject with Senators Clinton, Schumer, Hagel, and others.

In their report, the GAO has found, "Large numbers of military servicemembers are being targeted by a few firms offering life insurance products that provide limited benefits unless held for long periods, which most military purchasers were failing to do."

In fact, at least some of the companies understood, and apparently counted on, the fact that the target group for the life insurance sales were enlisted personnel, who have the highest level of turnover and would not hold these policies for long periods of time.

GAO also found, "Military members were being widely marketed a securities product, the contractual mutual fund plan, that has largely disappeared from the civilian marketplace and which had been periodically involved in sales scandals for decades."

The GAO reported that the marketing materials used were misleading and "misrepresented the advantages of these plans compared to other investments."

I think it should be a matter of very deep concern that these are not new problems. For example, *The New York Times* has reported that *Army Times* has described similar issues in earlier articles. Some military officials sought to alert Pentagon officials to the problems in a 1997 report. A 1998 report of the Pentagon's Inspector General, which looked into life insurance sales on 11 randomly selected military bases, found, "misleading sales presentations, presentations by unauthorized personnel, presentations to captive audiences, soliciting during duty hours, and soliciting in the barracks."

This was a Pentagon Inspector General's report.

A May 2000 Pentagon-ordered study by the former Chief Judge of the Army's Court of Criminal Appeals found that DoD policies "have been routinely violated" in this area for the last 30 years. I might also note that the SEC many years ago recommended banning the sale of mutual fund contractual plans altogether.

Furthermore, Mr. Chairman, there are also widespread abuses in the payday lending area directed specifically at our military personnel.

There are approximately 1.4 million active-duty personnel and 1.2 million members of the Ready Reserve and our armed forces. I am very concerned that any insurance company or agent or stockbroker or dealer would sell inappropriate financial products to our servicemen and women. I am very concerned that any lender would require economically abusive terms in loans to military personnel.

Now, we go marching around here waving the flag and everything about the military and the sacrifice of our men and women, and I have complete respect for what they do. But it seems to me one of the minimal things we could do to show that respect is to move aggressively against these kinds of practices which every study has found are abusive. I want to make that very clear that most of the reputable firms do not engage in this activity. But there are enough who do it in such abusive terms that it casts a dark cloud over the entire economic sector.

We are going to hear from a distinguished panel of witnesses this morning. I especially want to recognize Richard Hillman, now GAO's Managing Director for Financial Markets and Community Investment. Mr. Hillman is no stranger to this Committee, and I want to take this opportunity to commend him and his colleagues for their careful and thorough work on this important study. And I look forward to the second panel as well, and I should just note that I am delighted that Mary Schapiro, the Vice Chairman of NASD, will be on that panel. She is also no stranger to the Committee, and actually prior to joining NASD, she was Chairman of the Commodity Futures Trading Commission and also a Commissioner of the Securities and Exchange Commission. So she is very, very knowledgeable. She has been very helpful to this Committee in the past, and I look forward to hearing her testimony, as well as that of Ms. Richards from the SEC; Mr. Oxendine, who has come to be with us from the State of Georgia, the Insurance and Safety Fire Commission; and John Molino, the Deputy Under Secretary of Defense for Military, Community, and Family Policy of the U.S. Department of Defense.

Mr. Molino, I would just warn you now, we have this Inspector General study; we have other studies to the Pentagon about what is going on and so forth. So we are going to be curious to know why the Department of Defense itself has not moved more aggressively in this area heretofore. So, I would just put that out there so you can mull about it until we get to your panel.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Sarbanes.

Senator Enzi, I am going to recognize you next, but I do want to join Senator Sarbanes in recognizing your work and leadership in this area. This is a very important subject to all of us. Thank you.

Senator Enzi.

**STATEMENT OF SENATOR MICHAEL B. ENZI**

Senator ENZI. Thank you very much, Mr. Chairman, and I really appreciate your holding this hearing because this is an issue that is too important to ignore. For years, our men and women in the armed services have fallen victim to unscrupulous salespersons who are pushing high-cost financial products and life insurance. Oftentimes, the Department of Defense directives and the State regulations would be violated or completely ignored by these bad actors. The lack of oversight and information sharing among regulators has only made the problem more pervasive.

As this GAO report will show, salespersons have been preying on military personnel, who are often young, inexperienced in financial matters, and particularly vulnerable to the aggressive sales tactics used by come companies. In some examples, life insurance agents have posed as instructors arranging veterans benefits classes for recruits and trainees. The sales pitches would start as soon as the commanding officer left the room. Many young men signed contracts and made payroll deductions because they believed the policies were endorsed by the Department of Defense or their military branch. In reality, they bought life insurance policies with low death benefits and premiums as high as 14 times the price of similar plans offered by the Servicemembers' Group Life Insurance.

In other cases, military personnel were sold investments that have all but disappeared from civilian markets. These funds, called contractual plans, offer high up-front sales commissions that rob investors of years of earnings. Today, there are literally thousands of better investments on the market. However, financial advisers found a niche outside of the public mainstream where they could still sell these disreputable investments on our military bases.

In 1966, the SEC recommended to Congress that they ban these types of funds, but Congress did not act. It is time to finally follow through and ban the sale of these funds. My bill would do that.

One of the most troubling aspects of this issue is the lack of oversight by the Department of Defense. Throughout this GAO report, it is noted that the Department of Defense did not share information about these problems with other regulators who could have prevented these violations. The report states that DoD personnel would generally try to resolve issues within the base. It is very clear, however, that this method has only allowed the problem to persist. A better system of information sharing is needed to effec-

tively target bad actors and prevent them from ripping off our military personnel.

I believe that my bill, the Military Personnel Financial Services Protection Act, will address these critical needs. My bill would draw clear lines of jurisdiction for regulators, create a registry to track violators and ban the worst types of financial products being sold to our military. These products have disappeared from the civilian market, and they should disappear from military installations, too.

I am pleased that the GAO has recommended several steps that are already included in the bill. I look forward to the testimony of Mr. Hillman on how these reforms could best be enacted.

I would like to thank all the witnesses for appearing before the Committee today and sharing their perspectives. The investigations recently completed by NASD and SEC helped to bring this issue into focus for Congress. I appreciate their hard work. I am also interested to learn about the steps taken by the Department of Defense to better educate our armed forces about the financial investments they make, how they will provide better oversight in the future. I expect this GAO report and this hearing will advance the discussion of financial sales to our military personnel. During a time when so many of our armed services are bravely fighting tyranny abroad, we have to ensure that they are protected at home.

Thank you, Mr. Chairman.

Chairman SHELBY. The Chair recognizes Senator Schumer.

**STATEMENT OF SENATOR CHARLES E. SCHUMER**

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you and Senator Sarbanes for holding a hearing on this really important issue, on the sale of financial products to the military, and I want to thank Senator Enzi for his leadership in terms of legislation, which I am proud to cosponsor.

We all know the problems here, and when I first read the stories in *The New York Times*, it wrenches at your heart that the people who serve us were taken advantage of, and sometimes with the complicity not of the military, but with people in the military. When at Camp Pendleton the marines, 345 marines who bought life insurance through briefings that were sponsored by the camp, and they had these private insurance agents come in, the results, at least the research done by *The New York Times*, showed that those who signed up thought this product was endorsed by the Marine Corps. And that is just appalling. It really was very bothersome to me.

Now, it is a good question to see what DoD is doing. It is also a good question to ask the life insurance made available to military personnel by the Government, why is not that adequate? That is something we should think about in terms of our soldiers. But I think we should—and another question to ask is: Is the Department of Defense—why aren't they coordinating with other agencies in the Government who may have more expertise on these kinds of insurance products to try and figure out what they can do on their own.

I think the GAO's recommendations are exactly right. Banning the sale of contractual plans, known for the high front-end sales

charge of 50 percent, that makes sense. These plans, interestingly enough, are not in the civilian market at all, but they are being used to lure our soldiers. And I support their recommendations requesting that insurance regulators conduct reviews to ensure that the products being sold meet the existing insurance requirements. That seems to me to be rudimentary and fundamental.

Again, I think that Senator Enzi's bill does a very good job, and I am proud to be a cosponsor. Let me just make a couple of other points here.

One thing that was missing from the study were recommendations on steps to combat the negative effects posed by the automatic premium payment provisions which are included in many of these policies unless the servicemember proactively contacts the insurance company to cancel the policy and request a refund of the savings fund. This is an area where we might be able to help our soldiers and look at that.

Also, one legislative area we should look at that goes beyond the scope of the report, the way to improve disclosure provisions so that military members will know exactly what they are signing up for and understand which products automatically take payments from a member's bank account. That always is done quietly and people do not know it and they pay less attention to it.

I would also like to look into whether it may be necessary to work with DoD if there should be a certification requirement for the sale of products on military bases. That might go a long way to protecting people as well.

So, with that, Mr. Chairman, I thank you for this timely hearing and look forward to a legislative solution in large part based on the GAO recommendations.

Chairman SHELBY. Thank you.

The Chair recognizes Senator Bunning.

**STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important hearing, and I would like to thank all of our witnesses for coming here before us today.

I do not know anyone who read *The New York Times'* investigation of sales of financial products to the military personnel who was not at the very least appalled and concerned about the practices. Knowing some unscrupulous financial service companies are taking advantage of our servicemen and -women, most of whom are very young, deeply disturbed me, as I know it did many others in Congress.

Mr. Chairman, you and Senator Sarbanes asked for the GAO report that we are going to hear testimony on today, and Senator Mike Enzi has introduced a bill to curb some of the abuses. My good friend and fellow Kentuckian, Jeff Davis, the Congressman representing my old district in Kentucky, the 4th, has worked tirelessly on this issue and has introduced a bill very similar to Senator Enzi's that has already passed the House of Representatives. The SEC, the Nasdaq, and the State insurance commissioners have also been very involved in this issue. All of you should be commended for your efforts.

We have two large Army bases in Kentucky—Fort Knox and Fort Campbell. Like every other State in the Union, Kentucky has many Guard and Reserve units called up to fight the war on terror. If there is anything anyone can do to help facilitate financial education at the military facilities in Kentucky and prevent our service people from getting taken advantage of, please let us know. Let the Committee know and let the military bases know.

It sickens me to know some very bad actors have tried to take advantage of these young men and women as they go off to war. We must make sure that this does not happen anymore, and we must make sure that those who have abused our service people in order to make a quick buck are held accountable.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dole.

**STATEMENT OF SENATOR ELIZABETH DOLE**

Senator DOLE. Thank you, Chairman Shelby. My thanks to the witnesses this morning.

The unscrupulous sale of flawed financial products to our servicemen and -women is an extremely critical matter affecting our military families as well as our military's readiness. It is an appalling situation. Harmful financial products can cause serious financial hardships for servicemembers and their families, not only affecting morale but also causing military personnel to lose necessary security clearances and lead to career-ending disciplinary measures.

This is an issue I take very seriously as a Member of both this Committee and the Armed Services Committee. And with more than 115,000 military personnel stationed in North Carolina, these problems truly hit home.

I want to thank you, Mr. Chairman, and Ranking Member Sarbanes for requesting this important GAO report, which explains well the many reasons why military personnel are being targeted by dishonest financial services providers. This report has effectively painted a picture of the challenges affecting the men and women serving our country.

As we have already heard, many are young. In fact, the report points out that the Defense Department is the largest employer of young adults in the United States, having in 2004 recruited some 20,000 men and women into active duty alone, the majority of them recent high school graduates.

Also, our military members face lengthy deployments and frequent relocations, and like most young Americans, they often lack financial savvy and security. These very factors make them more vulnerable to predatory financial practices.

The GAO report also details the problems with certain insurance and securities products marketed to military personnel that have lower payouts and larger fees and commissions. Targeting the military to be consumers of these unscrupulous services deserves our closest scrutiny, and I, too, thank my colleague Senator Enzi for introducing such important legislation that takes significant action to stop these practices in the insurance and securities areas.

Still, I am concerned, Mr. Chairman that this report did not investigate lending practices to servicemembers. However, an April GAO report described tools that DoD is not fully utilizing to fight

predatory lending. It revealed that consumer advocates, State government officials, DoD officials, and servicemembers in GAO focus groups indicated that the military is being targeted and harmed by predatory lenders.

In the defense authorization bill that we passed this week, I was very proud to include an amendment that takes important action to stop predatory lenders from targeting our military. This measure requires the Defense Department, in consultation with Treasury, the Federal Reserve, the FDIC, and representatives of military, charity, and consumer organizations to report to Congress within 90 days on the prevalence of predatory lending and to provide specific legislative and administrative actions to prevent this egregious practice.

Indeed, supporting our military is more than just supporting their mission in the war against terror. It includes supporting their families and their livelihoods. The targeting of our servicemembers by unscrupulous financial service providers is seriously harming both, and I look forward to working with this Committee as we find ways to put a stop to all of these practices.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard is recognized.

**STATEMENT OF SENATOR WAYNE ALLARD**

Senator ALLARD. Thank you, Mr. Chairman. I, too, want to join my colleagues in thanking you and Senator Sarbanes for holding this hearing and my colleague from my neighboring State of Wyoming for taking the lead on this particular issue. I think it is important that we do closely examine the GAO report on the sale of financial products to military personnel. I am proud personally to represent a State with a significant military presence, and I look forward to the opportunity to hear from our witnesses.

I want to join my other colleagues also in saying we do owe our military a great debt. They volunteer to risk their lives to protect freedom and democracy. Therefore, it is only reasonable to expect that we would protect them against inappropriate sales of financial and investment products while on the job.

Having said that, we also want to be sure that we encourage savings through legitimate products. I think that we do not want to step over the line here. There are some very good savings plans, and we need to encourage our young people all over this country to do more to save, because in my view this country is not saving enough. Military people, with proper savings and investment programs, can enhance their future, and so I am looking forward to the testimony.

This GAO report, along with today's testimony, I think will be helpful in finding an appropriate balance, and I look forward to hearing from our witnesses.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Hillman, of course, the GAO report will be made part of the hearing record, and we appreciate that. Your written testimony will be made part of the hearing record. You proceed as you wish.

**STATEMENT OF RICHARD J. HILLMAN**
**MANAGING DIRECTOR, FINANCIAL MARKETS**
**AND COMMUNITY INVESTMENT,**
**U.S. GOVERNMENT ACCOUNTABILITY OFFICE;**
**ACCOMPANIED BY**
**CODY J. GOEBEL AND JACK EDWARDS**

Mr. HILLMAN. Thank you very much, Mr. Chairman. Accompanying me today, to my left, is Cody Goebel and to my right Jack Edwards. They are Assistant Directors at GAO who were primarily responsible for the successful design and implementation of the studies being featured today.

We are pleased to be here to discuss GAO's work on the sales of financial products to the U.S. military. Today, I will summarize the results of the report prepared at this Committee's request entitled "Financial Product Sales: Actions Needed to Better Protect Military Members." Specifically, I will discuss, one, the insurance and securities products that were being sold primarily to military members and how these products were being marketed; and, two, the ability of financial regulators and the Department of Defense to oversee the sales of insurance and securities products to military members. Where applicable, I will also present results from a related June 2005 study describing the need for DoD to implement controls over supplemental life insurance solicitation policies involving servicemembers.

In summary, regarding sales of insurance products, we found that thousands of junior enlisted servicemembers had been sold a product that combines life insurance with a savings fund promising high returns. Being marketed by a small number of companies, these products can provide savings to servicemembers that make steady payments and have provided millions in death benefits to survivors and others. However, these products are much more costly than the $250,000 of life insurance, now $400,000, that military members already receive as part of their Government benefits.

In addition, these products also appear to be a poor investment choice for servicemembers because they included provisions that allowed any savings accumulated on these products to be used to extend the insurance coverage if a servicemember ever stops making payments and fails to request a refund of the savings. With most military members leaving the service within a few years, many do not continue their payments, and as a result, few likely amassed any savings from their purchase.

Several of the companies who have sold these products have been sanctioned by regulators in the past, and new investigations are underway to assess whether these products were being properly represented as insurance and whether their terms were legal under existing State laws.

Regarding the sale of securities products, we found that thousands of military members were also purchasing a mutual fund product that also requires an extended series of payments to provide benefit. Known as contractual plans, they expect the servicemember to make payments for set periods, such as 15 years, with 50 percent of the first year's payments representing a sales charge paid to the selling broker-dealer. If held for the entire period, these plans can provide lower sales charges and comparable returns as

other funds; however, with securities regulators finding that only about 10 to 40 percent of the military members that purchased these products continued to make payments, many paid higher sales charges and received lower returns than had they invested in alternatively available products.

Regulators have already taken action against the largest broker-dealer that marketed this product and are investigating the few remaining sellers for using inappropriate sales practices. With the wide availability of much less costly alternative products, we and the relevant financial regulators question the need for contractual plans to continue to exist.

Sales to military members were receiving less oversight because DoD personnel rarely forwarded servicemembers' complaints to relevant financial regulators. Insurance products also lacked suitability or appropriateness standards that could have prompted regulators to investigate sales to military members sooner. Securities regulators' examinations of contractual plans were also hampered by a lack of standardized data showing whether consumers were benefiting from their purchases.

Although recognizing a greater need for sharing information on violations of its solicitation policy and servicemember complaints, DoD has yet to finalize its policies to require that such information be provided to financial regulators, nor has it coordinated with these regulators and its installations on appropriate ways that additional sharing can occur.

Given the concerns over potentially inappropriate financial product sales to military members, the need for definitive action to better protect servicemembers appears overdue. The report we issued to this Committee recommends actions by Congress that are consistent with the provisions and bills under consideration by this Committee. More specifically, because the features of the products being sold to military members provide limited benefits to many military purchasers, we believe that Congress should act to have all State insurance regulators conduct reviews to ensure that only legal products are being sold to military members and to have regulators work cooperatively with DoD to develop standards that could help ensure that companies only market appropriate products for military members' needs and circumstances.

Similarly, given the wide availability of less costly alternatives, Congress should act to amend the Investment Company Act to ban the sale of contractual mutual fund plans. Because financial regulators' ability to adequately oversee sales to military members was hampered by a lack of information sharing about military members' complaints and concerns, we also recommend that Congress direct DoD to work with insurance and securities regulators to overcome barriers to sharing information and to clarify that State regulators have jurisdiction on military installations.

In the report prepared for this Committee, we also recommend that DoD issue its revised solicitation policy that will require military personnel to share complaints with financial regulators. And, finally, to improve oversight by State insurance regulators, SEC, and NASD, we recommend these organizations designate specific members of their staff to receive complaints and conduct outreach by proactively learning of problems involving servicemembers. In

the event that contractual plans continue to be sold, we also recommend that the SEC and the NASD improve the information they have to evaluate the extent to which customers are successfully completing their plans.

DoD and the financial regulators have provided comments on a draft of this report being released today, generally agreeing with the report's contents and its recommendations.

Mr. Chairman, this completes my prepared statement, and I and my colleagues would be pleased to respond to any questions you or other Members may have.

Chairman SHELBY. Thank you, Mr. Hillman.

Could you assess for the Committee this morning the range and the quality of financial products offered to the military community as well as the sales methods employed to sell these products? And let me ask you this: What is the average age of these soldiers they are selling to? Did you do any work on that?

Mr. HILLMAN. Yes, we can provide information on that as well.

Chairman SHELBY. Okay.

Mr. HILLMAN. On the insurance products themselves, they were typically marketed to junior enlisted service personnel, those who have just come into the services and really just coming out of their basic training and being redeployed.

Chairman SHELBY. What would be the average age of these people? Young, would it not?

Mr. HILLMAN. Young, most often likely right out of high school, in their late teens and early 20's.

The contractual mutual fund plan, however, was more or less targeted to more senior, commissioned officers who had and could afford the ability to make payments for investment purposes.

The insurance companies targeting servicemembers were primarily marketing a hybrid product combining a high-cost insurance policy with a savings component. The product costs significantly more than other insurance coverage available to servicemembers. For example, since 2005, the Servicemembers' Group Life Insurance, or SGLI, provides $400,000 of life insurance for $26 per month. These other products would provide death benefits generally ranging from $25,000 to $50,000 for approximately $100 per month, allocating some funds to the savings fund, typically much less in the earlier years and more in the later years, depending on the product.

Another debilitating feature of the insurance products is that they had this automatic premium payment provision, as Senator Schumer mentioned in his opening remarks, which allows companies to deplete the savings fund to pay for any insurance premium should a servicemember stop making payments. Given that servicemembers more frequently move and leave the service within a few years, they are often unable to make payments for long periods of time, and because of this feature, have not been able or were likely unable to amass any savings.

Products also were associated with questionable sales practices where the agents were misrepresenting the products not as insurance but as an investment or identifying themselves as representatives of independent benefit and fraternal organizations. These products also frequently included very early and stiff withdrawal

penalties, and it was common for companies to credit the amount of accumulated savings on the basis of either the year-end balance or an average balance, whichever was less.

So, Mr. Chairman, overall on the insurance side, these products were more costly than what was available to servicemembers and were being touted as not insurance but investments, largely because of the incentive that members had to purchase insurance more cheaply through the Federal Government.

Chairman SHELBY. It is my understanding the Department of Defense has been aware of problems related to commercial solicitations on military installations since the Vietnam War era. Why are we still today discussing the same troubling issues 35 years later? And it is my understanding also that a lot of these contractual plan products they are selling disappeared from the civilian market 25 years ago due to their excessive sales charges. It looks to me like there is some exploitation going on here to kind of a captive young market—our soldiers.

Mr. HILLMAN. You are absolutely right. That was the most surprising thing to us as part of this study. As you have recounted and as have others, there has been a variety of reports out there in the 1990's and in the 2000 era that go back 10, 20, 30 years, recounting the types of problems they were having with the sales of these products. As we conducted work for this report before you as well as an earlier report in June 2005, we visited military bases. We talked with officers. We talked with junior and senior enlisted personnel. And we would be finding the same story as we were recounted in those studies. It is really quite remarkable.

Chairman SHELBY. I understand that the Department of Defense has banned only one company—one company—from military bases worldwide. I believe that was Academy Life Insurance Company in 1998.

In light of all the transgressions that have occurred over the past 20 years or more, I would ask this question: Should more be done to protect our men and women in uniform from unscrupulous actors? Senator Enzi has been in the leadership on this, as you know. Should more be done? And should we pursue legislation in this regard? Because I am not sure the Department of Defense could do it without legislation, or has done it. They have had a long time to do it.

Mr. HILLMAN. That is absolutely right. We were looking into the bill that Senators Enzi, Hagel, and Schumer introduced and find the provisions in the sections in the bill to be very relevant toward solving the problems servicemembers are facing. We have articulated certain important provisions within our report being released today, but believe that each of the sections in the bill being introduced have valuable contributions to protecting servicemembers.

In particular, because some States have reviewed the products sold to servicemembers on the insurance side and found them to be not in compliance with existing State laws, we are recommending that all State insurance commissioners review product provisions to ensure that they are in compliance with existing laws. As Senator Schumer said in his opening remarks, that is quite a fundamental requirement.

We have seen the State of Washington and others review products and find them to not be in compliance, and that is one quick and easy way to stop the sale of these products to military installations within those States.

Because State insurance commissioners have no authority to evaluate whether the products sold are appropriate or suitable for military members, we are also recommending—perhaps one of the more controversial recommendations—that State insurance commissioners and the Defense Department work together to develop appropriateness or suitability standards for sales of products to military servicemembers.

This has been a particularly contentious issue within the insurance industry, Mr. Chairman. As you know, the securities industry already has suitability standards, but such standards do not generally exist on the insurance side. On a limited basis, though, the insurance industry has acted where there are at-risk populations. For example, they developed suitability standards for senior citizens aged 65 and over as it related to the sale of annuity products. We are suggesting that the servicemember population is a similar at-risk group. Because of their itinerant lifestyle, moderate income levels, and young ages, they are particularly susceptible to abuse and, therefore, we are recommending that such standards be developed by DoD and the insurance industry to help curb this activity.

Chairman SHELBY. Senator Sarbanes is recognized.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Hillman, I again want to commend you and your colleagues for this extremely helpful report. I have a number of questions. The first I want to put to you is, to what extent was the Department of Defense allowing situations in which the agents trying to sell these products seemed to be clothed with some legitimacy from the Department? I mean solicitation on base or the use of certain military facilities, how they portrayed themselves so that their recruits did not perceive them as being as they were, a private vendor just trying to get a sale, but somehow could come away with the impression that it was somehow an approved activity by the Department of Defense, that it carried some imprimatur of approval as they were dealing with these people?

Mr. HILLMAN. As you know, Senator Sarbanes, one of the commonalities associated with the sales of these products—and I would like to have Jack Edwards also respond to this in more detail after I complete my initial remarks—one of the commonalities associated with the sale of these products is that they are often sold by agents who have had prior military service. Therefore, they are totally disarming the servicemembers that they are meeting with, giving them the impression that they are providing them with a product that is going to more than meet their needs because the agents have been where servicemembers are now.

Military personnel overseeing these activities do have a tough job. They are available and present, but the enforcement of their solicitation policies have not occurred in a fashion that we would have expected them to have occurred. There are requirements in the solicitation policy that go way back, prohibiting group sales that are prohibiting sales on barracks, and prohibiting sales during working hours, and repeatedly in reports you are seeing these

types of infractions taking place. So clearly, much more needs to be done by the Department of Defense to help ensure that the individuals who are on base soliciting information are doing in accordance with their policies.

Mr. Edwards.

Mr. EDWARDS. Yes. In the case of several of the installations where we visited, we did hear of cases of group presentations going on which are a problem because they have been prohibited by the directive which rules all of the commercial solicitation that occurs on the installations. This type of behavior is very difficult to quantify. There are not any statistics out there to suggest how often it has occurred.

However, one piece of information that we can put forward is that we did a survey of 175 DoD personnel financial management managers. These are people who are on military installations, who are in charge of programs to help enlisted people and officers with their financial concerns.

Senator SARBANES. These are DoD employees, is that correct?

Mr. EDWARDS. Yes. These managers indicated that several of the prohibited practices are going on. We could not confirm all of those because we did not visit all the bases. But in several cases we found 25 percent or more of that sample of 175 installation managers saying that prohibited practices were occurring on their bases.

Senator SARBANES. Your report notes difficulties and resistance in the Department of Defense in talking to other financial regulators about a number of these issues. Could you explain that to us a little bit?

Mr. HILLMAN. Yes. DoD has not shared concerns with complaints for several reasons. Base personnel prefer to work directly with the selling agents to resolve any matters, rather than working directly with the financial regulators. Some were concerned that discussions between servicemembers and financial regulators would be prohibited due to installations' legal advisers involvement in the complaint handling process. When individual servicemembers contact Judge Advocate General offices these advisers attorney-client privileges would prohibit them from sharing information further.

Upon further review with DoD regarding this matter, they now though believe that any legitimate request from an entity such as a financial regulator, could overcome the privacy or Judge Advocate General limitations.

Senator SARBANES. But generally speaking, they are not transmitting through to the financial regulators the complaints that they are receiving; is that correct?

Mr. HILLMAN. That is correct. They are not sharing information with the financial regulators, and they largely have not had a mechanism to even gather internally within DoD information on the extent to which there are concerns and complaints out there regarding these products.

Senator SARBANES. Right.

Mr. Chairman, my time has expired. Thank you very much.

Chairman SHELBY. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. I want to follow up just a little bit on what Senator Sarbanes was asking about.

There are known violators. How do they get access to the base? Is it a communication problem then? Is that what you are saying, and perhaps there are some base restrictions that keep them from sharing this information? I was not completely clear on what you were saying there, by known violators.

Mr. HILLMAN. The DoD attempts to take action on known violators, but there are a wide variety of agents that do come in on base that have not had violations in the past, and they are allowed in to provide for services to servicemembers in the insurance and securities area.

Regarding the fact as to whether or not there are limitations in the ability of the Defense Department to provide information to financial regulators, initially they were telling us, through most of our study, that, yes, that indeed was the case, that there were privacy concerns and other concerns associated with sharing information outside of the base, and their preference was to handle matters themselves rather than to involve the financial regulators.

Our understanding is, as a result of our work though, that the research that the Department of Defense has done now, they believe that there are no limitations to them sharing information about concerns and complaints of servicemembers to other financial regulators to the extent that they have a legitimate need to know.

Senator ENZI. Thank you. Along that same line, you examined the quantity and quality of complaints that were filed against insurance agents and held within the Department of Defense or on base. Can you give me a little insight into how a typical complaint is processed once it is filed, and how that is communicated?

Mr. HILLMAN. Maybe I should ask Mr. Edwards to respond to that.

Mr. EDWARDS. The actual procedure is probably going to vary a little bit by service, so what may be done in the Army may be a little different than in the Marine Corps; also it may vary somewhat according to the particular installation. But in some of the discussions that we had while visiting installations, typically servicemembers who thought that they were experiencing some kind of problem would go to the commercial solicitation coordinator for the entire base. This would be the individual who would certify whether an agent coming on the base was licensed, had had no problems on the base before and met certain other requirements.

After that, the coordinator would discuss what the problem was, whether certain activities had occurred, and whether those activities were prohibited practices. At that point the servicemember would be given an opportunity to go forward with the complaint or not. If it did go forward, then there would be various ways in which it could go forward. It might be with a criminal investigation, or it may be through some other channel.

Senator ENZI. Did you see any consistent patterns in the substance of these complaints?

Mr. EDWARDS. That was one of the interesting things. We ran into a problem in the work that was requested in the June report. We were asked to look at the incidence of violations. DoD does not gather information about the incidence of violations. It only is able to quantify those individuals who have committed actions that are egregious enough to result in banning. This is one of the reasons

that we recommended that DoD should be monitoring before something gets that severe. DoD partially concurred with our recommendation, and said the current Senate bill requires them only to monitor at the banned agent level.

Senator ENZI. Thank you. Mr. Hillman, did you encounter situations where the jurisdiction of the DoD and the State regulators was confusing, and did that cause inaction on the part of either party?

Mr. HILLMAN. Cody.

Mr. GOEBEL. Yes. We did hear that from regulators. We did some surveys as part of preparing this report and the report that Jack Edwards worked on. And although generally State insurance regulators and State security regulators expressed the opinion that they did have jurisdiction, there were a few that had some doubts about their complete jurisdiction. And in at least a couple of cases at some States that had large military populations, they definitely knew they did not have jurisdiction because some of these installations there are considered Federal enclaves, and so they did not believe they did, which was a concern.

What some States have done in light of that is, for example, investigators at the State of Maryland conducted some work and found violations at bases in that State and in the surrounding area. They actually reached out to the FBI and brought them with them in some of their initial consultations on the base to make sure they had a Federal connection. Investigators in Virginia also reached out and got permission from commanders at the base before they did any work. So that is how they have tried to address it.

Mr. HILLMAN. So this notion and this uncertainty about the extent to which they have legal authority is hampering their ability to go on base whether they have it or not. So legislation that you are introducing dealing with making it more clear that State securities regulators and insurance regulators have the jurisdictional right to go onto base to deal with sales practice issues is particularly important. We understand that this legislative jurisdiction requirement varies from one State to another, and we did not have the detailed time and resources to go in and look at each individual State and State activity.

However, we understand that the types of existing legislative authority over military installations varies significantly based upon when and how specific tracts of land were acquired and the like. So it is a confusing area and clarification would be much welcomed.

Senator ENZI. Thank you. My time has expired.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning is recognized.

Senator BUNNING. Thank you, Mr. Chairman.

In your report did you examine the recruitment policies of the Army, Navy, Marines, Air Force, and their explaining to recruits what benefits a recruit would have as far as life insurance or family benefits, and all the things that seem to be violated after the fact?

Mr. HILLMAN. Again, I would like to have Jack Edwards provide any information he may have about the report that he worked on looking at solicitation practices within DoD's policy. Our report

looked at the quality of the products that were being sold and the quality——

Senator BUNNING. After the fact.

Mr. HILLMAN. After the fact, and the quality of the regulation.

Senator BUNNING. So, I am a young man being recruited into the Army, for instance, the recruiter should be telling me now that, "Jim Bunning, you are going to have a $400,000 life insurance policy." I would like you to explain what is being done after the fact though.

Mr. EDWARDS. The military has a very strong program for looking at personal financial management. They try to do training for everyone who comes in. However, they have experienced some problems making sure that everyone gets through training. It was not in the report that we are discussing today about the supplemental life insurance, but another one of my teams did a report this year that looked at that education process, and it varies quite a bit among the different services as to exactly how they do the financial education. There are a wide variety of issues that are required as part of that financial training that each new recruit gets during periods which include the basic training and the initial follow-on installations where they go.

Senator BUNNING. Did you find out in your report that the violators, the people who violate the young service people, the people who are trying to sell illegal or unreasonable contracts, whether it be in mutual funds or life insurance, did they hit these recruits before they had completed basic training, or was it after the fact that they had finally made it through the basic training period, and then were members of the services?

Mr. EDWARDS. It could be in both situations, both while you are still in basic training, as well as in the follow-on assignments. However, one of the things that must be kept in mind is that the directive that DoD is operating under only controls the situation on the installations. Some servicemembers go out to the local mall or somewhere else and end up buying a policy, and DoD has less control over what occurs——

Senator BUNNING. I understand that. That is not my question. My question is the time between when they enter as a recruit until the time they finish, is the Department of Defense giving the recruit enough information on the benefits, and therefore, preventing our giving a heads-up to these young people, that there are people that could be trying to sell them illegitimate insurance policies, contractual mutual fund policies and on down the line?

Mr. EDWARDS. We did not look specifically at that issue.

Senator BUNNING. You didn't?

Mr. EDWARDS. No.

Senator BUNNING. All right.

Mr. GOEBEL. Senator.

Senator BUNNING. Yes.

Mr. GOEBEL. We also, in our report, have a recommendation to the Department of Defense to expand some of the subjects they cover in their personal financial management training, not so much on the benefits of the products as you are discussing, but on what to do if they do have concerns or complaints, notifying them of who to complain to, the regulators, the insurance or the securities regu-

lators. We also found that although DoD is attempting, as Jack has said, to get that training to all new recruits, there was some desire expressed by some servicemembers we talked to to see that held at all levels, because as we mentioned, not all of these products are targeted to the early——

Senator BUNNING. What I am saying is if something is eliminated 25 years ago from the civilian sales force, the recruit would have the same opportunity to complain to the NASD, to the Securities and Exchange Commission, or any other regulator. I know they are very young and very unsophisticated investors, but the fact of the matter is they have the same rights and privileges that anyone who is not in the service has. My only desire is to make sure that what is good for people outside the service is also good for them when they get in.

Mr. HILLMAN. Well, the Service Members Life Insurance Program is well-supported by military servicemembers. Well over 90 percent enroll into that program, so they know that they have insurance. But oftentimes what regulators are telling us is, that these insurance products that are being sold to military members are being not sold as an insurance product, but are being sold as an investment.

Senator BUNNING. I can understand how that would happen, and that also can try to be happening in civilian life. The fact that somebody is 19 and right out of high school and the proximity of going into war, they would never think that they had enough life insurance. The fact of the matter is that if informed of what is available at the military level and the upgrading of the military life insurance policies that we as a Congress has taken under, would have a great deal of effect on what they do as individuals.

Thank you.

Chairman SHELBY. Thank you, Senator Bunning.

Senator SARBANES. It is $400,000 now, is it not?

Mr. HILLMAN. That is correct, absolutely.

Senator SARBANES. Right.

Mr. EDWARDS. Plus $100,000 in death gratuity benefit that everyone would get even if they were not covered by the insurance.

Chairman SHELBY. Plus survivor benefits, education for children, and so forth.

Senator BUNNING. Oh, it is a package.

Chairman SHELBY. In addition to that. I am not saying it is sufficient, but we owe them a lot.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. The huge benefits that can occur, such as for a widow, did not used to be true. But, if they have a family of two children and the widow, you can easily figure out over a lifetime their accumulated benefits could be over a million dollars. I do think that they need some financial consultation. I understand they are providing that.

But the thing that comes to my mind is what motivates the Department of Defense to think they need to have a salesman on the job? I mean these men and women in the armed forces, they are working. It is on-the-job sales. I would not let a salesman come in and sell to my employees while they are working for me. Why do they think that is important? I am trying to think why an employer

would allow that to happen. When I have employees working for me, I want them to do the job. If they have something they want to buy, they do it on their own time. So my question is, why do we even allow a salesman of any kind on the base?

Mr. HILLMAN. I may have Jack answer this question as well, Senator, but I agree with your view that the insurance coverage that is being made available for military members today is very generous. The investment options being made available to military members through their Thrift Savings Plan is equally very generous. You have no-load programs, low-cost operating funds available for servicemembers to invest at least 7 to 10 percent of their income into these Thrift Savings Plans.

Chairman SHELBY. Do they all know that? That is important, to communicate that to them.

Senator ALLARD. Yes, which is available to any Federal employee.

Chairman SHELBY. Right.

Senator ALLARD. Yes. I need a response to my question of why do we let salesmen on the base where they are working?

Mr. EDWARDS. A military installation is a little bit different than your usual corporate location because we do have people actually living on the bases. They will be on there after their work day ends. And in the case of people who are living in community family housing on the installations, they may arrange to have someone to actually come to their house. Or it may be the case that the military member buys a policy from someone who comes to a designated area that the installation commander makes available.

So part of it is a difference between the military working environment and the civilian working environment.

Senator ALLARD. It sounded to me like, when we were putting this together, they had a group of soldiers together, and this guy would come in while they were in uniform, came in and made this sales pitch, and it does not seem quite appropriate to me. If they are home or whatever, that is probably a different story.

Senator SARBANES. Did they solicit in the context in which Senator Allard just suggested?

Mr. EDWARDS. Yes. If you look back at the report from 1999 DoD IG, the Cuthbert Report, and our report, each suggests some solicitation was going on during work hours in work situations. You do have some situations like those that are documented for Camp Pendleton, where individuals did get solicited in groups, which is a prohibited activity, much like contacting somebody during the work hours.

Senator ALLARD. The other thing, when they came in and marketed, I assume they approached the soldiers pretty much as this was a savings mechanism, a financial investment. Was this in relation to IRA accounts or was it Keogh plans, or how were they structuring the sales to start with? I personally have been approached by these people with an IRA account, for example, who say this is strictly a savings account, but when you get into it, you find out you bought life insurance or some part of that is life insurance, and it is very expensive. This sounds to me like the same mechanism that we have here. Are they coming in and trying to market an

IRA account, not knowing that they have a Keogh plan, or was something like that available?

Mr. GOEBEL. Yes. The securities product, the contractual plan, was largely being sold, from what we understand, as a Roth IRA, as a retirement vehicle for the servicemembers.

Senator ALLARD. Same types of stuff we run into in the private sector. We ran into them in the 1970's particularly, if I recall, although they just had them as IRA accounts at that time, and they are deceptive. The salesman persisted that this was not life insurance, but it was there in black and white if you read the fine print. I can understand how they can get misled on that kind of stuff, and I think that it is a shame.

Mr. HILLMAN. The SEC and the NASD will be on the next panel, can speak very vividly to practices being undertaken by the largest seller of this contractual plan, who they identified through scripts that were being provided to agents, just how egregiously they were touting the limitations of other products and services, and propping up the products and services that they were selling.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Hillman, what single action by the Department of Defense, the insurance commissioners, the Congress, or any other interested party would have the greatest impact on this decades-old problem in your judgment? Would it be strong, meaningful legislation, as Senator Enzi has proposed, or what would it be?

Mr. HILLMAN. As it relates to the Department of Defense, they have a major mission and a massive responsibility. It is one of the biggest organizations in the world. They need help. The need to solicit the assistance of experts who know about the quality of the financial products and who know about problems concerning sales practice abuses. They need to outreach more to financial regulators. That, in our view, would be the one major area where we could help to curb this type of activity at the SEC, at the NASD, indeed within State insurance regulators and the NAIC. They do not have resources to look at every issue that may come up as a part of an examination and their approach, therefore, is more risk-based, more risk-focused.

One of the key ingredients in determining the extent to which risks exist comes from complaints and concerns that they might hear. That will trigger to them a potential problem, that will give them an opportunity to review that problem, see to whatever extent it exists, and to deal with it.

Chairman SHELBY. As we all know, we are dealing with a young population as a rule, a very vulnerable population, considering they know they are going to be in harm's way, more than likely. So the tendency would be—I think Senator Allard or somebody alluded to the fact—to buy insurance to protect their families, protect their loved ones. Probably more so than the average person, would you think?

Mr. HILLMAN. I would think so.

Chairman SHELBY. I think we owe them more than we have done.

Senator Sarbanes, do you have any other questions?

Senator SARBANES. No, I know we have another panel coming, Mr. Chairman.

Chairman SHELBY. A very important panel, too.

Senator SARBANES. Yes, it is an important panel. These—have been very helpful and I am sure we are going to stay in close touch with them as we proceed on this issue.

Chairman SHELBY. Senator Allard has an observation.

Senator ALLARD. The point I wanted to make is this—they are not up front about selling life insurance.

Chairman SHELBY. Yes.

Mr. HILLMAN. Right.

Senator ALLARD. They make the argument they are selling an IRA account and it is in a savings account.

Mr. HILLMAN. Right.

Senator ALLARD. In reality, it is a partial life insurance policy that they are selling.

Mr. HILLMAN. And what you are finding also, Senator Allard, is that the way in which the premiums on these policies are being allocated in the earlier years, the years that servicemembers are likely to make payments, a significant portion of those premiums go toward the high-cost insurance. A very limited portion go toward the savings fund. Only in the out years do the maximum portion of the premiums go toward the savings funds, and of course that is when the servicemembers, for their own personal reasons, likely have dropped out.

Senator SARBANES. Is there not information from the companies, like internal memos and so forth, where they are relying in fact on these sales items not being carried through to get the benefit in the later years? It is all part of their calculation as to how to make a much larger profit out of what they are doing; is that not correct?

Mr. GOEBEL. Yes, Senator, in our report we quote from some of the internal memos that were obtained through depositions in a previous court case, where one of the company officials was attempting to overcome objections within his own company as how can their firm could sell this and promise this high rate of return that is not feasible. And he told them: "No, no, do not worry about it, we won't really ever have to pay that amount out, 40 percent will drop out in the first year." And so the products, the way they were structured and designed seemed almost deceptive to us.

Chairman SHELBY. I personally believe that companies that are doing business this way, as you describe, exploiting our soldiers, should be banned or something. You know, I do not know exactly how we are going to do it, but we are going to look seriously, Senator Sarbanes and I working with Senator Enzi and others, Senator Allard, on legislation.

Thank you so much, Mr. Hillman, you and your other people at the Government Accountability Office. As usual, you have done great work.

Mr. HILLMAN. Thank you. It has been our pleasure.

Chairman SHELBY. We are going to call up the second panel. Mr. John Molino, Deputy Under Secretary of Defense for Military Community and Family Policy, U.S. Department of Defense; Ms. Lori Richards, Director, Office of Compliance, Inspections, and Examinations, the U.S. Securities and Exchange Commission; Ms. Mary

Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, National Association of Securities Dealers; and Mr. John Oxendine, Insurance and Safety Fire Commissioner for the State of Georgia.

I want to welcome all the members of the panel. Your written testimony will be made part of the hearing record of the Committee in its entirety. We would like for you to sum up your top points and your views and observations here, where we will have a chance this morning to have a dialogue with you.

Mr. Molino, we will start with you.

**STATEMENT OF JOHN M. MOLINO**
**DEPUTY UNDER SECRETARY OF DEFENSE**
**FOR MILITARY COMMUNITY AND FAMILY POLICY**
**U.S. DEPARTMENT OF DEFENSE**

Mr. MOLINO. Thank you, Mr. Chairman. Thank you for having this hearing and for the opportunity to express three basic sentiments and then, with your indulgence, I have been making notes all throughout the first panel and would like to say a few things in that regard.

First, I want to express the Department's appreciation to the Committee for the interest you have taken in the well-being of our troops and their families by holding this hearing and by probing into the quality of the products targeted for sale to them.

Second, I want to express the Department's eagerness to collaborate with those who share our goals and are not motivated by maximizing their profits at the expense of our servicemembers and their families.

And finally, I want to express the Department's commitment to maintain the effort to do what is right in this regard and in the best interests of those men and women who selflessly serve to protect the freedom that most of us enjoy and, unfortunately, too many of us take for granted.

We want our troops to be informed consumers with access to quality products both on and off our military installations. Working with the Congress, the individual States, regulators, and other concerned entities, I believe we can achieve this goal.

Now, all that I have said might be empty rhetoric, and Senator Sarbanes rightly cited a series of reports and recommendations that apparently fell on deaf ears across Administrations and across sessions of Congress. Soon after I came to the current position I am in, in the second half of 2001, my staff brought to me this historic record that has been cited frequently. I asked many of the same questions that you people have asked today—how could this have gone on so long, how could this be going on today?

Chairman SHELBY. But it is.

Mr. MOLINO. Yes, sir it is. What we did was we began revising policy, staffing that policy. And of course, when you begin to staff policy within the Pentagon, it does not stay within the Pentagon. We reached out to several Government agencies, we reached out to nonprofits to develop an education program which is now having an impact, and the statistics are showing us that there is a dramatic decrease in the number of servicemembers who report having difficulty making ends meet or paying their bills. We cooperated, in-

deed, with *The New York Times* reporter who did that wonderful exposé. We have cooperated with the GAO and others in Government, as Senator Schumer has suggested we should do.

And what are the results to date? We are not there yet, by no means. There have been several enforcement actions, most notably at Fort Benning, Georgia, which have come to public attention. There has been legislation that we find, frankly, very helpful. There has been collaboration with States and nonprofits. And this has occurred despite enormous pressure from the insurance industry. I am happy to report, however, that many of the letters I received from Congress initially saying why are you being so tough on the insurance industry have now shifted to tell me that I am not being tough enough. And I welcome those letters.

We are still, unfortunately, under a restriction imposed by the Congress that tells me that I cannot revise my regulations in this regard without first giving 30 days' notice, and I presume that is to allow those who do not share our opinions of moving forward with reform to advise you of why these are bad ideas.

We welcome the offers of help from the Hill. We want to cooperate in every way. Many of the actions recommended by the GAO, we have already taken, and our other actions in the process are consistent with the GAO's report and their recommendations. We endorse the GAO's recommendations as they deal with State regulators and the suitability standards. We would welcome that kind of guidance.

My commitment is where the Department of Defense is the problem, we will become part of the solution. We welcome Congress's help in allowing the good work we are doing on base and we welcome anything you do to allow that to extend off the installation, outside the gate.

Why hasn't DoD nor the Congress acted sooner than beginning a few years ago? I cannot answer the question. I suspect there are reasons, but I would submit to you that none of those reasons are acceptable.

Let me end by restating one salient point. This is an issue that I think is on the road to a solution primarily because the Department of Defense chose to turn over some rocks that had been sitting dormant for many years. We welcome the airing that this issue is getting. We welcome the help of a legislative nature, of a regulatory nature, from our nonprofit partners, from Congress, and from those who share our interests.

I would be happy to entertain your questions, Mr. Chairman.

Chairman SHELBY. Ms. Richards, on behalf of the Securities and Exchange Commission.

**STATEMENT OF LORI RICHARDS**
**DIRECTOR, OFFICE OF COMPLIANCE,**
**INSPECTIONS, AND EXAMINATIONS**
**U.S. SECURITIES AND EXCHANGE COMMISSION**

Ms. RICHARDS. Thank you. Chairman Shelby, Members of the Committee, I am pleased to appear before you today to testify on behalf of the SEC and to express the Commission's views with respect to the GAO's report. My testimony today will address those portions of the GAO's report that deal with securities products.

The Commission strongly believes that our servicemen and servicewomen must be protected from illegal and abusive practices in the sale of securities. Over the last year, the Commission and its staff have undertaken a comprehensive program to address such practices. Our program has included enforcement activity, extensive examination activity, including two examination sweeps, close coordination with the Department of Defense and the NASD, and finally, investor education.

My written testimony summarizes all of these actions in some detail, so I will just touch on them this morning.

First, the Commission brought an enforcement action against First Command Financial Planning, a broker-dealer that, as you heard this morning, specializes in the sale of securities products, namely contractual plans or also called periodic payment plans, to military personnel. The Commission's enforcement action ordered First Command to cease and desist from illegal and abusive sales practices in the sale of those securities and also included an order to pay $12 million, $5.2 million in restitution to military customers and the remainder, importantly, to fund an investor education program for military members and their families, to be administered by the NASD.

Second, we have also mobilized our troops on this issue. The Commission's examination staff has conducted numerous examinations of broker-dealers that sell securities to military personnel. SEC exam staff initiated two separate risk-targeted examination sweeps, one focusing on the sales of mutual fund contractual plans or periodic payment plans, and the other examination sweep focusing more generally on the sales of securities products to military personnel. The examination sweeps included on-site reviews of broker-dealer firms serving the military market and visits to these firms' sales offices located in military base communities both in the United States and overseas.

In total, the SEC staff thus far—and I emphasize that our work is ongoing—we have examined or are in the process of examining about 20 broker-dealer firms with locations near base communities, including firms with sales offices near Marine and Navy bases in San Diego; near Lackland and Kelly Air Force bases in San Antonio, Texas; near Fort Hood in Killeen, Texas; near the Great Lakes Naval Training Center in North Chicago, Illinois; near Rammstein Air Force Base in western Germany; near Graffenwoer Army Base in eastern Germany; and finally, near Aviano Air Force Base in Italy. More examinations are anticipated.

Third, the Commission staff have worked closely with the Department of Defense and have established a regular liaison with the Office of the Secretary of Defense, through which we have begun to share information and coordinate our examinations. We have also—and this is very important—coordinated our efforts with the commands, the local commands of selected bases where we have had our examiners go and visit. This coordination is continuing, with the Department of Defense providing us with information that we are using to target our examinations.

Finally, our staff in the Commission's Office of Investor Education and Assistance have initiated an investor education program directed specifically toward members of the military and their fam-

ilies. As a charter member of the DoD's Financial Readiness Campaign, we have assisted in the presentation of financial education programs to the military. SEC staff have already conducted several financial education workshops on military installations. We have also initiated education materials about periodic payment plans specifically and published an article in *Military Money,* a publication that is distributed free in the military community. In all of these efforts we have worked closely with the National Association of Securities Dealers.

With respect specifically to the GAO's report, we strongly agree with the GAO's recommendation that Congress should take legislative action in this area to protect military servicemembers. We recommend that you take steps to address the particular features of these plans that make them susceptible to abusive and misleading sales practices and excessive fees.

We strongly agree with the GAO's recommendation that Congress revisit the law governing mutual fund contractual plans. As an alternative to an outright ban on these plans, we believe that Congress could consider addressing the excessive sales charges which are features of these plans by, for example, reducing the maximum allowable load or working with the Commission and the NASD on other mechanisms that would provide protection against excessive sales loads.

In addition, in the event that periodic payment plans are not banned, securities regulators will consider various means of better assuring ourselves that we have adequate information to assess the sales of these plans. Should the plans not be banned, we will continue to work with other regulators to ensure that we can have better oversight over their sales.

In addition, with respect to the GAO's other recommendation, we have already taken action to enhance our information-sharing with the DoD, consistent with the GAO's recommendation, and we will continue to work with DoD to help us target examinations.

More broadly, we look forward to working with this Committee, the DoD, the NASD, and other regulators to continue to protect members of our military as investors in our markets.

Thank you. I am happy to answer any questions you have.

Chairman SHELBY. Thank you, Ms. Richards.

Ms. SCHAPIRO. As Senator Sarbanes, welcome again to the Committee. You spend a lot of time here.

**STATEMENT OF MARY SCHAPIRO**
**VICE CHAIRMAN AND PRESIDENT,**
**REGULATORY POLICY AND OVERSIGHT**
**NATIONAL ASSOCIATION OF SECURITIES DEALERS**

Ms. SCHAPIRO. Thank you very much. It is very nice to be here, Chairman Shelby, Senator Sarbanes, and Senator Enzi. Thank you very much for the opportunity to come before the Committee and testify about NASD's efforts to protect members of the armed forces from abusive and misleading sales practices.

This morning, I would like to briefly summarize NASD's work in this area. We have prepared a comprehensive written statement and, with your permission, will submit it for inclusion in the record.

Chairman SHELBY. Without objection, it will be made part of the hearing record.

Ms. SCHAPIRO. Thank you.

As you know, Mr. Chairman, America's men and women in uniform make great personal sacrifices to protect our Nation's security. They in particular should not have to worry about the honesty and the integrity of those who purport to help them make sound financial decisions. Yet, thousands of mostly young men and women who serve in the military have been disadvantaged by sales of investment products called periodic payment plans, or contractual plans.

In 2003, NASD learned that First Command Financial Planning of Fort Worth, Texas, a broker-dealer with many ties to the military, using misleading pitches and improper sales tactics, had targeted and sold more than a half a million of these complicated and often extremely expensive products to servicepersons, many of whom were young and inexperienced investors. We have responded forcefully to end these practices by, punishing those responsible for them, ensuring that their victims are recompensed for their losses, and establishing an education campaign about investing and saving aimed at military personnel.

As you heard this morning from GAO, an investor in one of these plans makes monthly payments of as little as $50 for a fixed period of time, usually 15 years. The payments are invested in mutual funds, and the investor is charged a 50 percent sales load, or upfront fee, on the entire first year's payments. Payments during the remainder of the 15-year term are not subject to sales loads, so that the effective sales charge decreases so long as that investor can continues to make contributions. However, if the investor stays in the plan for more than 45 days, yet fails to make contributions over the full 15-year term, he or she can pay a sales charge of up to 50 percent of the total amount invested.

After a thorough investigation, including taking testimony from 16 current and former First Command employees, reviewing more than 25,000 pages of documents, and over 50,000 e-mail messages, NASD brought disciplinary action against the firm, in coordination with the Securities and Exchange Commission. The firm was, as Ms. Richards said, censured and fined $12 million in December 2004. That amount included restitution to thousands of customers who had terminated periodic payment plans after January 1, 1999, and had paid effective sales charges greater than 5 percent.

As of October 18, over $4.3 million had been returned to these customers. The remaining funds were transferred to the NASD Investor Education Foundation to be dedicated to the development and deployment of comprehensive financial education programs for members of the armed services and their families. Working closely with the Defense Department and the SEC, we expect to launch a multifaceted military financial education program early next year.

Like any regulator, NASD relies on customer complaints as an important source of information about improper sales tactics. Here, there were no complaints to NASD. We subsequently learned servicepersons had complained to military attorneys, but those lawyers could not relay this information to NASD without specific consent from their clients. We therefore support the GAO recommendations

that would facilitate reporting of military investors' concerns and complaints about financial products to the appropriate regulators. NASD has designated staff to receive complaints from military personnel and to conduct outreach with DoD to proactively learn of issues concerning securities sales.

Finally, Mr. Chairman, I note that Senator Enzi has introduced a bill that would ban the sale of periodic payment plans. His bill also recognizes that in situations where an investor is highly dependent upon a broker for advice and guidance, immediate access to full information, including the disciplinary history of the broker, can be crucial. Learning about your broker's history after purchasing can be too late. A provision in the bill would allow NASD to disclose to investors via the Internet the disciplinary history of brokers and firms. Currently we can only disclose this information by telephone or in writing or e-mail. Investors are not able to receive the information directly from their search. The bill would allow investors to get this crucial information the way they have told us they want it—online in real time. Thus far in 2005, 3.7 million online searches were conducted on BrokerCheck, and only 50,000 over the telephone. Investors clearly prefer to receive their information via the Internet.

NASD supports this bill and appreciates all of this Committee's efforts to protect the financial well-being of our men and women in uniform and, indeed, all investors.

This concludes my statement, and I thank you again for the opportunity to be here and I would be happy to answer any questions.

Chairman SHELBY. Thank you so much.

Mr. Oxendine.

**STATEMENT OF JOHN OXENDINE**
**COMMISSIONER OF INSURANCE,**
**STATE OF GEORGIA**

Mr. OXENDINE. Thank you very much, Mr. Chairman. My name is John Oxendine. I am the Insurance Commissioner of the State of Georgia. I want to thank the entire Committee for giving me this time to testify.

I will be testifying on behalf of insurance regulators from all of the States which together make up the National Association of Insurance Commissioners. I am also testifying in my capacity as the Georgia Insurance Commissioner and will share some unique experiences.

On behalf of all State regulators, I would like to make three points. First, that America's men and women serving in the armed forces are entitled to the same protections under State law enjoyed by all other American citizens. Protecting insurance consumers at the local level has been a hallmark of State regulation for more than a century. Each State has a strong unfair trade practices law backed by a dedicated staff that is trained to assist consumers.

Second, State regulators recognize that those serving our country in the military deserve special attention from responsible State and Federal officials. We are actively reaching out to the military authorities to educate them about States' consumer education and consumer protection resources and to coordinate with local bases in our enforcement activities.

Third, State insurance regulators do support Federal legislation that would clarify our authority to regulate the business of insurance wherever it occurs, including military bases both within the United States and overseas. We believe that H.R. 458, with some minor revisions, would help achieve these goals.

In Georgia, I have personally been investigating sales abuses involving military personnel and have recovered approximately—or proposed $1.5 million in refunds for Georgia's soldiers alone. And that is the first initial wave. We have held hearings, we have listened to sworn testimonies of soldiers stationed in Georgia. Based on my investigation, I do have two major concerns.

First concern is that insurance agents gain access to young soldiers through their relationships with the staff sergeants and that young soldiers place too much trust in the agents based on the agents' relationships with their sergeants. Many agents themselves are retired sergeants who know their way around the bases and know those in charge. Other agents develop relationships with sergeants by being good citizens. They help fund projects related to the morale, which of course are needed for our troops. For example, insurance agents may provide Thanksgiving turkeys to needy military families or they may sponsor on-base activities for the enlisted personnel.

While not illegal, such favors do generate goodwill between the sergeants and the agents. Then, when the agents approach the young soldiers, they have an in, because they are friends with the sergeants. If a young soldier asks his sergeant about an insurance agent who has approached him, he is typically assured that the agent is a good guy and trustworthy. In some cases, young soldiers come to this conclusion on their own. For example, one soldier testified that he willingly got into the car and rode to a pizza party with an agent who he did not know simply because he had seen the agent talking to his first sergeant and assumed that the agent was trustworthy.

The problem, of course, is that some agents are not trustworthy. Sometimes they sell unsuitable products. Most soldiers already purchased the affordable SGLI and may not need supplemental life products. These supplemental policies are often sold to soldiers as investments rather than as insurance. While it is true that an insurance policy can be one component of an individual's investment strategy, the investment portion of the policy is, in some cases, being overemphasized and/or misrepresented. Some soldiers have testified that they did not even realize that they had purchased life insurance. Some also testified they thought they were opening a savings account.

Second, another concern I have is that nationally there is a culture that discourages military personnel from requesting assistance from civilian State agencies, such as insurance departments. In Georgia, we have recently shown that this culture can be reversed.

In conclusion, we all share a commitment to serving insurance consumers who are serving our country in the military, and there are no easy answers or solutions. To address the problems, I would suggest, first, that we educate the NCO's so that they do not appear to endorse or recommend companies or agents that have provided financial assistance to our enlisted personnel; and second,

that we encourage the NCO's, the morale and financial counselors, and the JAG officers to work with State regulators to educate the soldiers and to share information about potentially abusive sales practices.

Thank you, Mr. Chairman, and I will be happy to address any questions.

Chairman SHELBY. Thank you.

Secretary Molino, you, I believe, said a few minutes ago that we were not there—meaning DoD—you are not there yet. But with all due respect, 35 years to look under all the rocks? You said we continue to look under the rocks. I think Senator Enzi and GAO have found a lot of deep problems on top of the rocks. And we will get more into this as we go, but 35 years is a long time.

Ms. Richards, I want to direct a question to you toward the SEC. The dominant retailer of contractual plans has been an SEC-registered broker-dealer subject to the SEC Commission's inspection and compliance regime for almost a half a century. Why did it take a series in *The New York Times* last year to trigger an investigation at the SEC into this company's deceptive marketing materials and sales practice? I understand that NASD had already begun its inquiry before the *Times* investigation was published. We know who this is, but it is troubling.

Ms. RICHARDS. Yes, sir, we had conducted, and the NASD had also conducted examinations of this particular firm.

Chairman SHELBY. We are glad you are doing it, but we wonder why it took so long.

Ms. RICHARDS. Yes, sir. During the course of that examination, we had received information from the firm which indicated to the examiners a very high persistency rate; in fact, about 80 percent, we were told, of investors in the contractual plans maintained them for the full 15-year period. That is a pretty significant rate. That information, coupled with the fact that we had no customer complaints—we did not see any customer complaints either on our own records or in the firm's books and records—led us not to look further. It was not until we had early indications from the press that in fact the persistency rate, that period of time in which the investors——

Chairman SHELBY. The press is doing a good job here.

Ms. RICHARDS. Yes, sir, a very good job.

Chairman SHELBY. Give them credit.

Ms. RICHARDS. Yes, a lot of credit.

Chairman SHELBY. Maybe not every day, but——

[Laughter.]

Ms. RICHARDS. We then, based on those inquiries, we went back into the firm, and at that point we were able to obtain information along with the NASD that led us to conclude that in fact the earlier persistency rates that we had been provided with were not accurate. And in fact, that firm had a much lower rate of investors holding the security through the entire 15 years. In fact, we concluded that about 43 percent of the firm's investors held the security for the full 15-year period.

The lesson for us, I think, in this examination experience as well as in additional examinations we have done more recently of firms that sell periodic payment plans is that there really should be—and

we agree with the GAO—there really should be better tools to allow securities regulators to see what the actual persistency rates are. And we would support requirements for broker-dealers to maintain those kinds of books and records and make them available to examiners.

Chairman SHELBY. Ms. Schapiro, why did the largest retailer of contractual plans voluntarily decide last year to stop offering them? I understand that this financial services company sold about 90 percent of all plans in the United States. Given their departure from this market right now, what does the future hold for contractual plans? Which mutual fund companies sponsor contractual plans and what are the justifications they offer for sponsoring plans with such high sales charges? With hundreds of no-load mutual funds available today, it seems to me that a 50 percent sales charge would be difficult to justify. It would be out in the marketplace and it should be on the base. I know this is a lot of stuff.

Ms. SCHAPIRO. That is a multipart question. I probably will not remember all the parts, so you should interrupt me.

Chairman SHELBY. I bet you would.

[Laughter.]

Ms. SCHAPIRO. To start at the last part, you are absolutely right, there are tremendous alternatives now for investors to a plan such as First Command Financial Planning was selling. There are about 1,300 mutual funds, by our count, that allow you to make monthly or periodic contributions of as little as $50, and many of those are no-load funds with no up-front costs at all. So to my way of thinking, this is largely a product that has outlived its usefulness, because there are much better, lower-cost alternatives.

Chairman SHELBY. I think you have to put this in the context that these are young soldiers, for the most part, vulnerable, as I said earlier, worried about getting in harm's way—living and dying.

Ms. SCHAPIRO. Right.

Chairman SHELBY. And so forth.

Ms. SCHAPIRO. Well, they are not——

Chairman SHELBY. A little different from the ordinary us, everyday.

Ms. SCHAPIRO. In fact, that made it easier, I think, for these broker-dealers to market these plans. This was, as somebody said earlier, a captive audience and they had——

Chairman SHELBY. But not an audience to exploit, I hope.

Ms. SCHAPIRO. No, absolutely not. This is an audience that deserves the highest levels of protection in every aspect of what they do, whether it is insurance purchases or securities sales or anything else.

I believe First Command stopped selling the product as a result of the enforcement actions taken by the NASD and the SEC. They realized that this is not a product that is suitable for the vast number of young, inexperienced investors to whom they were selling it, particularly given the fact that so few were able to maintain their contribution levels over the entire 15-year period, which was the only way this plan made any sense for these young people.

Chairman SHELBY. Mr. Oxendine, what is the status of the investigations under way by various State commissions? I know you rep-

resent the State of Georgia, but you also are representing your fellow commissioners here at the table today. That is, examining the activities of the companies that market to military members.

Mr. OXENDINE. Yes, Mr. Chairman. I actually am the lead investigator, or lead State, on a multistate investigation into numerous different companies.

Chairman SHELBY. But you come from a State with some huge military bases.

Mr. OXENDINE. We do. We have seen a lot of activity both at Fort Benning, Fort Steward, and a little less at Fort Gordon. We were the first State to initiate an investigation. Therefore, when the NAIC decided to do a multistate national investigation, Georgia was asked to chair that, and we are chairing that. We are actually very close to wrapping up and, hopefully, settling the first of those investigations that we started. That was with American Amicable. We are working with that. The other investigations with several other companies are ongoing.

Chairman SHELBY. The GAO, among other things, reported here today that some States—I do not know about Georgia, but maybe some others—are finding that the products being sold to military members do not actually comply with your own State insurance laws. How did such products obtain approval originally, and what are the individual State commissioners doing to ensure that only legal products are sold? Has something fallen through the cracks here?

Mr. OXENDINE. What has happened is one product, Horizon Life was a product that was offered, that product has been removed from the streets in Georgia and in several other States. But they were often filed with our offices as separate products. And where as separate products there was nothing wrong with them, when they were bundled into a package, then we had concerns with them and they started to violate various portions of State laws. They were not—there was no indication that they would ever be sold as a package. In the civilian market, you would have people starting to complain. What happened in the military community, people did not complain.

Chairman SHELBY. This is a captive audience, too, is it not?

Mr. OXENDINE. And they know soldiers are not going to call their State government. We found that that was not happening. And the military was not calling their State government. That can be changed. Fort Benning, Georgia, for example, we share confidential documents together, we work together on sensitive issues, and have a great relationship, and I think that relationship can be done throughout the country and I think the Senate can help promote that.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. I see a vote has started so I will be very brief, because I know you will need to draw to a conclusion.

First of all, I want to thank the panel. It has been very helpful testimony. I have just a couple of questions I want to put.

I would say to NASD and the SEC, I commend you for the actions you took. I mean, this company found it could push the Air

Force around but it could not push NASD and the SEC around. You have had to deal with some pretty big players in the past, in terms of meting out sanctions and punishments. So, I mean, I think they came up—you know, they finally got into a league where they could not just rely on old contacts and to get people to back off of trying to curb these practices.

Mr. Molino, why does the military allow pay allotments to be used to pay for private-sector products? Am I correct that these recruits could do a check-off here and the money would be withheld and sent to the company for these products? Is that correct?

Mr. MOLINO. That is correct, Senator.

Senator SARBANES. Why do you allow that?

Mr. MOLINO. The allotment system has been around for a very long time.

And the reason for that is in recognition of the nature of military duty, there are many deployments, there are many times even when you are not deployed, you are off training. And when the bills come into the mailbox, without the allotment system what you would find are people missing payments of their bills because they are not writing the checks.

Senator SARBANES. Who can get on the allotment system?

Mr. MOLINO. What we found, Senator, was that the abuse of the allotment system was the nature of the problem—thanks to the people who did the investigations—where salesmen had actually worked out deals on some installations where they were delivering allotment forms to finance offices and getting them processed.

Senator SARBANES. Well, how could that be happening? How can the military allow that practice?

Mr. MOLINO. That is in direct violation of existing policy, and that should not have happened. And where it has been exposed, it has been stopped. But you are exactly right in that the allotment system is provided as a aid and a resource for our servicemembers that has been abused by some of these predator salesmen.

Senator SARBANES. It seems to me, I mean, I am supportive of what Senator Enzi is trying to do. Those are steps beyond. But there are a lot of existing regulations or practices that the military has which have not been enforced—they have not been implemented here—which would have at least avoided some of these exploitations that have taken place. Am I correct in that perception?

Mr. MOLINO. You are correct, yes, Senator.

Senator SARBANES. I mean, that could be done immediately.

Mr. MOLINO. It should have been done years ago. And in fact, our inquiries into the status of this undertaking and this activity have revealed these violations that we have addressed and attacked.

Senator SARBANES. Do you challenge the right of the State regulators, their authority over insurance sales on military bases? Or do you think—I am asking Mr. Molino, but it is a point that Mr. Oxendine raised—or is it your view that they have the authority to regulate these——

Mr. MOLINO. It is our view that there is sufficient authority out there to permit that. And as Mr. Oxendine points out, Georgia being a good example, that with a little communication we realize that these barriers are not nonexistent, that we can actually work together and collaborate, share information.

Senator SARBANES. Is it your perception that the military is any way inhibiting or putting up roadblocks to the State regulators' exercise of authority?

Mr. MOLINO. I would agree with what I think the GAO's conclusion was; that if that is occurring, it is occurring out of a misinterpretation of the existing statute and regulations and that we clear that up as we clarify with our attorneys.

Senator SARBANES. Well, could you go back from this hearing and start clarifying that immediately? You do not need any authority to do that.

Mr. MOLINO. I think it is fair to say that we are already engaged in that. And I think my colleagues would agree.

Senator SARBANES. Why do we not intensify it a little bit so the State regulators can get on the job?

Mr. MOLINO. Happy to do it, Senator.

Senator SARBANES. Mr. Chairman, I have a lot of other questions, but I will defer to my colleague.

Chairman SHELBY. Keep the record open on this, if we would. Senator Enzi.

Senator ENZI. Mr. Chairman, I was just going to make a request that you keep the record open.

I have a number of questions. This is an outstanding panel and, as you know, my accounting background tends to make for fairly detailed questions and those usually result better in written answers———than they do in spoken answers. So if you will leave the record open and I can submit questions.

Chairman SHELBY. We respect that.

I want to say before—we have a vote on the floor and I am going to recognize Senator Schumer next—but I want to say again, Senator Enzi, that your leadership in this area is very much appreciated. And this has been noted by us up here, your colleagues, but also everywhere else today.

Senator ENZI. Thank you.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. I am not an accountant, so I will ask the more direct questions. Lawyer. Never practiced. Was elected to the Assembly instead of practicing.

I know Senator Shelby touched on this, Mr. Molino, but I am just amazed that this went on for so long and it took a newspaper to uncover it. What have you done to prevent the next scandal from occurring so it does not go on another 30 or 35 years and we need another newspaper to uncover it? I mean—and not just on insurance or even mutual funds, but all these kinds of things. Payday lending is an example.

Mr. MOLINO. Senator, I am not an accountant and I am not a lawyer, I am a soldier. But I grew up in Brooklyn, so that might help.

Senator SCHUMER. Oh, well. I think, then, you are doing a great job.

[Laughter.]

What high school did you go to, Mr. Molino?

Mr. MOLINO. I went to Xavier, sir, on 16th St.

Senator SCHUMER. Oh, Xavier is a great school.

Chairman SHELBY. And he wants to know how many family members you have voting.

[Laughter.]

Senator SCHUMER. That is why the Chairman has been so successful for so long.

Mr. MOLINO. Mr. Chairman, I suspect the Senator's success relies on the fact that he already knows how many family members I have voting.

[Laughter.]

Senator, you are asking me to predict something that is very, very tough to get at.

Senator SCHUMER. I just want to know what steps the military has taken to prevent the next problem.

Mr. MOLINO. Let me just say one thing about—I alluded to it in my oral statement, but the conversations that I have had with Diana Henriques, who is *The New York Times* reporter who wrote the outstanding series of articles, began not with "I think you have a problem, let me ask you some questions," it began with something akin to "I understand you have uncovered some problems and I want to write about it." And we then opened a very aggressive dialogue to ensure that she had access and information so that she would be able to reflect an honest portrayal of where we were.

What I said in my statement is I cannot and, Senator Sarbanes, I will not even begin to apologize for 35 years of neglect in this regard. I have a frustration. I have been in this job since June 2001, and I am frustrated that we have not moved further than we have. In the oral statements of my colleagues here, I counted 13 references to close collaboration or coordination with the Department of Defense. Not a very lucky number, but I am proud of it. That has come about because the Department said we have a problem here, we need to address it.

Senator SCHUMER. Can you—I am sorry to interrupt——

Mr. MOLINO. No, no, I understand the time limitation.

Senator SCHUMER. —but, first, we are both from Brooklyn, we always interrupt one another——

Mr. MOLINO. Absolutely.

Senator SCHUMER. But second, can you please tell me specifically what steps have been taken to prevent the next scandal from happening? Do you go monitor now what is happening? Do you survey soldiers at random as to what kind of products they are buying? Do you check about those products?

Mr. MOLINO. We do. We post on our website those who have been banned, whether their company or the agent has been banned. We have a policy that is about ready to be implemented, once we get the approval and we pass the 30-day waiting period imposed by the Congress, that will require all individuals who have been solicited to complete a questionnaire—who solicited you, what is the quality of that solicitation, do you think you were pressured?

Senator SCHUMER. And that would be given out randomly, even to bases that——

Mr. MOLINO. No, sir, it will be given out in 100 percent of the cases. It is a requirement——

Senator SCHUMER. Not in the—100 percent of the soldiers?

Mr. MOLINO. Yes, sir. It will be a requirement for someone, to solicit on an installation, to, at the end of that solicitation, leave the form with the individual. And that form does not get returned through the agent, it gets returned through the commanding office.

Senator SCHUMER. Would you support certifying representatives who are selling products?

Mr. MOLINO. Absolutely.

Senator SCHUMER. That is good.

Mr. MOLINO. Yes, sir.

Senator SCHUMER. That is very good.

Mr. MOLINO. Absolutely we would do that.

Senator SCHUMER. Okay. That would be a dramatic change.

Mr. MOLINO. And, sir, insofar as payday lending, which is my next campaign that we are currently undergoing, I can assure you that I get besieged with requests from individuals who would like to be on my calendar to tell me how noble a business that is and how they are much better than credit unions and banks. I do not believe that is the case. I am not on their Christmas list and they are not on mine.

Senator SCHUMER. Right. Okay, let me ask you this. You talked about coordination, you mentioned 13 times. Is there a set system in place? Because we are hearing from some other agencies that they think coordination could be better.

Mr. MOLINO. Yes, sir. The GAO, in fact, has said that.

Senator SCHUMER. I know.

Mr. MOLINO. That coordination could be better. And I suspect——

Senator SCHUMER. So what can you do to make that better so there is real coordination between your colleagues here and everybody else in the military? We do not expect the military to be financial experts. We do expect them to rely on the financial experts in Government to protect the soldiers.

Mr. MOLINO. You are exactly right. We have memorandums of understanding with upward of 30 private agencies and governmental agencies to enhance our education effort. And I think, through the memorandum of understanding and the memorandum of agreement systems, we can secure that. And we endorse the GAO's recommendation that others who are experts advise us on suitability of these products. We welcome that advice.

Senator SCHUMER. And you will do that as part of the certification process as well?

Mr. MOLINO. Absolutely.

Senator SCHUMER. That is good.

Mr. MOLINO. Yes, sir.

Senator SCHUMER. Let me ask you this. Again, you are not a lawyer. Do we expect any—or have criminal laws been violated and would we expect, from your knowledge—I know we do not have U.S. attorneys here, we do have some of the people who might refer cases—do we expect any criminal indictments coming out of this?

Mr. MOLINO. I cannot answer that, Senator. I know that at the installation level the staff judge advocates look to see if there are criminal violations that should be recommended to the commands. And there have been cases—Fort Benning, as Mr. Oxendine cited—where nonjudicial punishment in the Uniform Code of Military Jus-

tice was employed on some of the situations that he cited, where——

Senator SCHUMER. So it is a possibility; you just cannot comment on it, is what you are saying?

Mr. MOLINO. I think if you break the law you deserve to get punished in that way.

Senator SCHUMER. And is that a possibility that that could happen in some of these cases?

Mr. MOLINO. I suspect that is always a possibility, yes, sir. But I would not want to prejudice——

Senator SCHUMER. I am not asking a specific case, I am asking—you do not prejudice. I can tell you that much as a lawyer, I know.

Mr. MOLINO. The bottom line is I do not want anybody to get off just because I prejudiced a statement that says they probably will be punished.

Senator SCHUMER. Okay. Would any of the other panelists—Ms. Richards, Ms. Schapiro—want to comment on the possibility? Have potential criminal laws been broken here?

Ms. RICHARDS. The SEC, as you know, Senator, is a civil enforcement agency.

Senator SCHUMER. I know. But you do referrals.

Ms. RICHARDS. We do. As an examiner, I am not aware of any ongoing criminal probes.

Senator SCHUMER. And Ms. Schapiro.

Ms. SCHAPIRO. I am not aware of any ongoing criminal probes. We do have several investigations still ongoing within the NASD of other brokerage firms.

Senator SCHUMER. Let me ask you to just look into that, to see if there are criminal violations. Because if there are, I mean, as everybody here said, you read these stories and it just wrenches your guts out. And if somebody broke the law, they should be punished for it. I mean, it will set an example as much as the prophylactic things we are doing in the future. So, I would make a request that you redouble your efforts and see if that has happened and then make the appropriate referrals—which you do, both agencies do.

Ms. RICHARDS. Absolutely.

Senator SCHUMER. Are you both willing to do that?

Ms. RICHARDS. Yes.

Ms. SCHAPIRO. Yes.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Our time on the floor is about gone, Senator. I hope they will wait for Senator Schumer, and I will tag along.

Thank you very much for appearing here today. I believe it has been an informative panel, and this gives us some more insight as to why we need to correct this problem. Thank you.

[Whereupon, at 12:04 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

United States Government Accountability Office

GAO

Testimony
Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

For Release on Delivery Expected at 10 a.m. EST Thursday, November 17, 2005

# FINANCIAL PRODUCT SALES

## Actions Needed to Protect Military Members

Statement of Richard J. Hillman, Managing Director Financial Markets and Community Investment

GAO-06-245T

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss GAO's work on the sales of financial products to members of the U.S. military. In 2004, a series of media reports highlighted allegations of financial firms marketing expensive and potentially unnecessary insurance and other financial products to members of the military. These accounts included claims of insurance companies improperly selling insurance as investment products and broker-dealer firms marketing a mutual fund product with high upfront sales charges that was rarely being offered to civilians. These media reports raised concerns within Congress and elsewhere over whether the men and women in the armed services were as adequately protected from inappropriate financial product sales as their civilian counterparts.

Today, I will summarize the results from the report being released today that we prepared at this committee's request, which is entitled *Financial Product Sales: Actions Needed to Better Protect Military Members*.[1] Specifically, I will discuss (1) the insurance and securities products that were being sold primarily to military members and how these products were being marketed, and (2) the ability of financial regulators and the Department of Defense (DOD) to oversee the sales of insurance and securities products to military members. Where applicable, I will also present results from a related report entitled *Military Personnel: DOD Needs Better Controls over Supplemental Life Insurance Solicitation Policies Involving Servicemembers*.[2]

In summary:

A limited number of firms accused of using deceptive sales practices are targeting costly financial products to military members with features that reduce their benefits to military purchasers. About six insurance companies are marketing products that combine high-cost insurance with a savings component. Although some service members and their survivors have benefited from these products, many have not. Most of the purchasers of these products were unmarried individuals with no dependents and thus may have had little need for more coverage beyond that already provided through the low-cost government insurance offered to service members. In addition, these products also appeared to be a poor investment choice for service members because they include provisions that allow the money accumulated in the savings fund to be used to keep the life insurance in force if the service member ever stops making

[1] GAO-06-23 (Washington, D.C.: Nov. 2, 2005).

[2] See GAO-05-696 (Washington, D.C.: June 29, 2005).

payments and does not request a refund of this savings. Given that military members move frequently and often leave the service within a few years, many did not continue their payments and failed to cancel their policy and request refunds, and as a result, few likely amassed any savings from their purchase. Since the 1990s, state regulators, law enforcement authorities, and DOD have taken various actions against the few insurance companies that sell these products to military members and current investigations are continuing in as many as 14 states. Among the allegations being investigated is whether these companies are violating state laws by failing to clearly identify the products as insurance. In addition, several states are also reviewing whether the products' features comply with all state insurance requirements. Similarly, a small number of broker-dealers were marketing a securities product—the mutual fund contractual plan—that has largely disappeared from the civilian marketplace. Although potentially providing returns equivalent to other products if steady payments are made over a long period of time, these contractual plans proved more expensive to most military purchasers than other widely available alternative products because many military members stopped making payments in the first few years. Securities regulators are also concerned over the practices used to market these products and the largest broker-dealer selling contractual plans recently agreed to pay a $12 million penalty to settle Securities and Exchange Commission (SEC) and NASD allegations that it used misleading marketing materials. In addition, these regulators are currently conducting examinations into practices of the other firms that also marketed these products to military members.[3]

A lack of routine complaint sharing between financial regulators and DOD was the primary reason that regulators did not generally identify the problematic sales of financial products to military service members until such accounts appeared in the media. Although insurance regulators in some states review sales activities periodically, insurance regulators in most states generally rely on complaints from purchasers to indicate that potentially problematic sales are occurring. One reason that insurance company sales activities are not reviewed more extensively is because most states lack any appropriateness or suitability standards for insurance products. Although conducting periodic examinations of broker-dealers sales practices, securities regulators' ability to identify problems involving the sale of contractual plans was also hampered by the lack of complaint sharing from DOD personnel and the absence of standardized information on the extent to which contractual plan purchasers were successfully making their payments.

[3]NASD, formerly known as the National Association of Securities Dealers, oversees the broker-dealer firms and their registered sales representatives that market securities.

Because sharing with financial regulators can be complicated by privacy regulations and potential legal restrictions, DOD personnel at individual installations generally resolved matters involving product sales with the service member and the companies directly. However, in light of the problems identified in our June 2005 report and the report we issued for this committee, DOD has efforts underway to revise its solicitation policies regarding such sales and has reviewed ways in which it can legally share additional information with financial regulators. However, DOD has not yet issued these new policies or coordinated with its installation personnel or with regulators on appropriate ways that additional sharing can occur. State insurance and securities regulators also expressed concerns over whether their jurisdiction over sales of financial products on military installations was sufficiently clear.

Given the concerns over potentially inappropriate financial product sales to military members, the need for definitive actions to better protect service members appears overdue. The report we issued to this committee recommends actions by Congress that are consistent with many of the provisions that seek to improve protections for military members in the bills that passed the House of Representatives and are under consideration in the U.S. Senate.[4] Because the features of the products being sold to military members provided limited benefits to many military purchasers, we believe that Congress should act to have all state insurance regulators conduct reviews to ensure that only legal products are being sold to military members and to have regulators work cooperatively with DOD to develop standards that could help ensure that companies only market products appropriate for the military members' needs and circumstances. Similarly, given the wide availability of less expensive alternatives, Congress should act to amend the Investment Company Act to ban the sale of contractual plans. Because financial regulators' ability to adequately oversee sales to military members was hampered by a lack of information sharing about military members' complaints and concerns, we also recommend that Congress direct DOD to work with insurance and securities regulators to overcome barriers to sharing information and to clarify that state regulators have jurisdiction on military installations. In the report prepared for this committee, we also recommend that DOD issue its revised solicitation policies that will require military personnel to share complaints with financial regulators. To improve oversight by state insurance regulators, SEC, and NASD, we recommend that these organizations designate specific members of their staff to receive complaints and conduct outreach to proactively learn of problems involving military members. In the event that

[4]*See* Military Personnel Financial Services Protection Act, H.R. 458, 109th Congress (2005) and Military Personnel Financial Services Protection Act, S. 418, 109th Congress (2005).

contractual plans continue to be sold, we also recommended that SEC and NASD improve the information they have to assess the sales of contractual plans. DOD, SEC, NASD, and the National Association of Insurance Commissioners (NAIC) provided comments on our current report and indicated that they intend to take steps to consider and implement our recommendations.

## Costly Financial Products With Features Inappropriate for Military Members Raise Sales Practice Concerns

A limited number of insurance companies and broker-dealers are under investigation for deceptive sales practices to target military members with financial products that have features that reduce their benefit to service members. Although most service members already receive considerable low-cost life insurance as part of their government benefits, state insurance regulators we contacted said that at least six insurance companies have been selling a hybrid insurance product that combines life insurance coverage with a side savings fund to thousands of service members at installations across the United States and around the world. For example, four of these companies were licensed to sell insurance in at least 40 states, and the other two licensed in at least 35 states and five of them had received DOD approval to conduct business at U.S. military installations overseas. These insurance companies also appeared to market primarily to junior enlisted service members. According to state insurance regulators we contacted, the companies primarily sold insurance policies to military personnel during their first few years of service, including during their initial basic training or advanced training provided after basic training.

Although the exact number of service members that have purchased these products is not known, regulators told us that these companies sell thousands of policies to military personnel each year. We also found evidence that large numbers of these products were being sold. For example, base personnel at one naval training facility we visited said they regularly received several hundred allotment forms each month to initiate automatic premium payment deductions from military members' paychecks for these insurance products.

These products provide additional death benefits but are significantly more expensive than other life insurance coverage available to service members. For example, service members purchasing these products make payments of about $100 per month for additional death benefits generally ranging from $25,000 to $50,000. In contrast, all service members are currently able to purchase $400,000

of life insurance through Servicemembers' Group Life Insurance (SGLI) for $26 per month.[5]

Although the insurance products these six companies were selling also included a savings component that recently promised to earn interest between 6.5 and 8.1 percent, these products also included features that reduced the likelihood that service members purchasing them would accumulate large amounts of savings. As we reported, military members move frequently and many leave the service after a few years, which which may reduce their ability or willingness to continue making payments to fulfill a long-term financial commitment. However, the products being marketed by these insurance companies require a long series of payments to result in significant benefits to their purchasers. For example, most of the payments made in the earliest years—ranging from 1 to 7 years—would be used to pay the premiums for life insurance coverage. In subsequent years, more of the service members' payment would be allocated to the savings component.[6] In addition, these products also included features that allowed the companies to use the money accumulated in a service member's savings fund to automatically pay any unpaid insurance premiums. Although this would extend the period of time that these service members would be covered under the insurance policy, data we obtained from several of these companies indicated that 40 percent or more of the service members that purchased these products stopped making payments within the first 3 years. With regulators indicating that most purchasers failed to request refunds of their saving fund balance, few likely accumulated any savings as a result of their purchase.

According to our analysis, the amount of time that it takes for a service member's savings fund on these combined insurance and savings products to become totally depleted through the automatic payment provision varied. Figure 1 shows

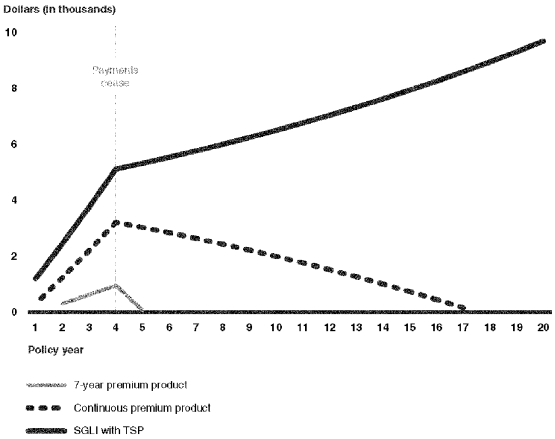
[5]Previously, service members were automatically covered for the maximum amount of $250,000 of insurance on their first day of active duty status, unless they declined or reduced their coverage. Included in the Emergency Supplemental Appropriations Act of Defense, the Global War on Terror, and Tsunami Relief, for the Fiscal Year Ending September 30, 2005, Pub. L. No. 109-13, sec. 1012 (May 11, 2005), were provisions that increased this amount to $400,000 effective September 1, 2005. This act also increased the death gratuity paid upon a service member's death from $12,000 to $100,000, under certain circumstances.

[6]For example, for a $100 monthly payment for the product sold by three of the companies 100 percent of the first year's payments would be allocated to the insurance premium. Between the second and the seventh years, 75 percent of the purchaser's total payment would be allocated to the life insurance premium and 25 percent would allocated to the savings fund. After 7 years, all of the total payment would be allocated to the savings. Three other companies sold products that allocated 75 percent of the total payment to the life insurance premium during the first year, followed by 25 percent in subsequent years.

the impact on a service member who purchases the product providing $30,000 of insurance coverage that requires full payment of the total life insurance premimium during the first 7 years. As the figure shows, the money in the savings fund of a service member who makes the required $100 monthly payments for 4 years and then stops paying would be totally depleted to pay the subsequent insurance premiums in just over 1 year. This occurs because of the large premiums due in the early years on this type of policy, and because the accumulated value of the savings fund for this product was modest. For the other type of insurance and savings product typically being sold to military members, which involves lower but continuous premium payments over the life of the policy, service members who halt their payments after 4 years would have accumulated sufficient savings to extend the $30,000 of life insurance coverage for another 13 years. In contrast, a service member could have used the $100 monthly payment to instead purchase $30,000 of SGLI term coverage at a cost of only about $23 per year and invest the remainder into the Thrift Savings Plan (TSP), which is the low-cost retirement savings plan available to military members and federal employees. Although ceasing payments on SGLI after 4 years would terminate the service member's life insurance, the money contributed to the TSP and left to earn just 4 percent interest would grow to about $9,545 in 20 years.[7]

[7] While in the service, a service member can purchase SGLI and contribute to the TSP. If a service member leaves, he or she may elect to purchase Veterans' Group Life Insurance (VGLI) and can either leave any accumulated savings in TSP, withdraw the money from TSP, or roll over the TSP balance into a similar savings instrument, such as an individual retirement account. In addition, we used the low risk TSP G Fund for this calculation because it invests in interest bearing securities and thus was comparable to the interest earning products offered by these insurance companies.

**Figure 1: Total Approximate Future Values of Insurance Products' Savings Fund and TSP with Payments Ceasing after Year 4**




Source: GAO analysis.

## Insurance Companies Accused of Inappropriate Sales Practices to Military Members

The companies that market primarily to military members have been subject to actions by state insurance regulators, the Department of Justice (DOJ), DOD, and others. In the report we prepared for this committee, we identified at least 17 lawsuits or administrative actions that had been taken against companies that market primarily to military members. In many of these actions taken by state and federal regulators, federal law enforcement organizations, or others, the companies have been accused of inappropriate sales practices and agreed to settlements as part of lawsuits or administration actions involving fines, refunds, and other actions. For example, in December 2002, DOJ announced a settlement against an insurance company that had marketed a combined insurance and saving product primarily to military members in which the company paid a penalty and agreed to no longer sell insurance in the United States. According to the DOJ complaint, this company had allegedly defrauded military service members who purchased life insurance policies from the company by having its

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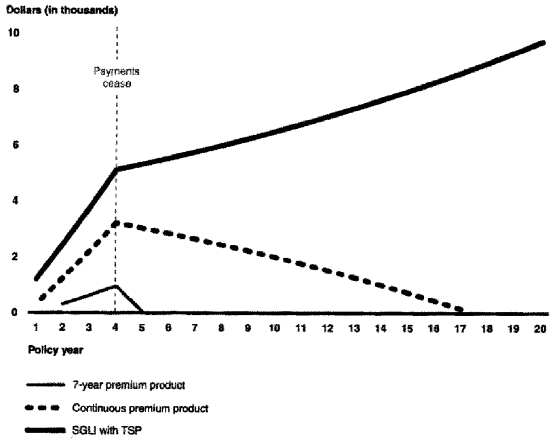


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military service members who purchased life insurance policies from the company by having its agents pose as independent and objective counselors representing a nonprofit fraternal organization that offered, as one of its benefits, the ability to purchase the company's life insurance.

The insurance companies that marketed primarily to service members have also been accused of violating DOD's own solicitation policies for many years. For example, a 1999 DOD Inspector General report and a DOD-commissioned report issued in 2000 found that insurance companies were frequently employing improper sales practices as part of marketing to service members. Among the activities prohibited by DOD that the Inspector General's report found were occurring included presentations being made by unauthorized personnel, presentations being made to group gatherings of service members, and solicitation of service members during duty hours or in their barracks. More recently, DOD personnel conducted an April 2005 proceeding in Georgia to review the practice of one of the companies currently being investigated by state insurance regulators regarding allegations of multiple violations of the DOD directive on insurance solicitation. Among the practices alleged at this hearing were misleading sales presentations to group audiences and solicitations in unauthorized areas, such as in housing or barracks areas. DOD recently began maintaining an online listing of actions taken against insurance companies or their agents by various DOD installations. As of August 11, 2005, this web site listed 21 agents from some of the 6 companies that market primarily to military members that are permanently barred—or have had their solicitation privileges temporarily suspended—at 8 different military installations.

Our own work also found that problems involving sales of insurance products to military members appeared to be widespread. We reported in June 2005 that DOD only recently began systematically collecting and disseminating information on violations of DOD's solicitation policy by sellers of financial products.[8] However, as part of that report, we also surveyed DOD personal financial training program managers and found that nearly 37 percent believed that insurance company representatives had made misleading sales presentations at their installations during 2004, with 12 percent believing that such presentations were occurring routinely. At the two bases visited as part of work for this report, we also found evidence that problematic sales to service members were occurring.

[8]GAO-05-696.

For example, our review of statements taken from 41 service members that military investigators interviewed at one Army base indicated that more than 70 percent of the service members said that the insurance sales personnel had described the product being sold as a savings or investment product rather than as insurance, which violates state insurance laws. Additionally, many of these service members also described conduct that appeared to represent instances in which insurance company sales personnel had violated one or more of the restrictions in DOD's solicitation policy, such as making these sales presentations during group training sessions.

In addition to these past actions, insurance regulators in as many as 14 states are also conducting examinations of these six insurance companies, as well as others that market to military members. Among the issues that regulators are investigating are whether representatives of these companies have not been clearly identifying these products as insurance, as state laws require, but instead marketing them as investments. Regulators and other organizations are also examining whether the sellers of these products are misrepresenting information on the forms used to initiate pay allotments to deduct the payments for the products directly from the service members' pay.

In addition, insurance regulators in some states are currently reviewing whether these combined insurance and savings products that are being sold to military members comply with all applicable state insurance laws and regulations. For example, regulators in Washington state rescinded approval to sell the products that had previously been approved for sales by some of these companies because the savings component, which the companies had been labeling as an annuity riders, was determined to not meet that state's annuity regulations.[9] Regulators in Virginia also recently ordered three companies that marketed primarily to military members to cease sales of combined insurance and savings products because of concerns over whether these products adequately complied with that state's insurance law. However, although these products may be marketed in as many as 46 states, currently only 14 states are involved in such reviews of the legality of these products. As a result, in the report we prepared for this committee, we recommend that Congress act to have

[9]In an annuity contract, an insurer agrees to make a series of payments for a specified period or for the life of the contract holder, providing insurance against the possibility that the contract holder will outlive his or her assets during the period covered under the contract.

insurance regulators in all states conduct reviews to ensure that the products being marketed to military members adequately comply with state insurance laws.

## Companies also Selling Service Members a Mutual Fund Product with Features that Reduce Its Benefit to Most Military Members

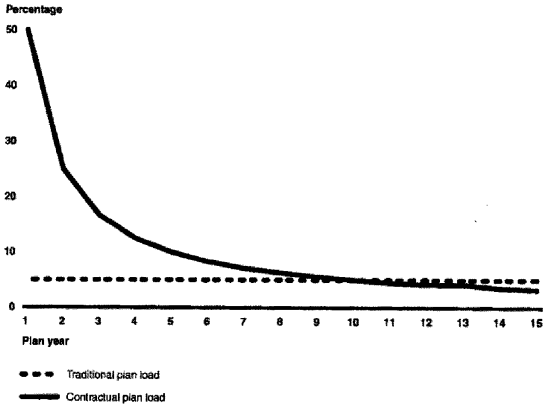
Large numbers of service members, including officers, were also purchasing a unique securities product, known as a contractual plan, with features that reduce its benefit to military members. Under the terms of the contractual plans sold to military service members, they would be expected to make monthly payments of a set amount for long periods, such as 15 years, that would be invested in the mutual funds offered by some of the largest mutual fund companies. Under the terms of the contractual plan, the broker-dealer selling the product deducts a sales charge (called a load) of up to 50 percent from each of the first year's monthly payments with generally no further sales load deductions thereafter. In contrast, conventional mutual funds typically deduct loads that average 5 percent from each contribution made into the fund. According to regulators, about five broker-dealers accounted for the bulk of contractual plan sales to military members. According to the marketing materials of the broker-dealer that was the largest seller of contractual plans, this firm had nearly 300,000 military customers, with an estimated one-third of all commissioned officers and 40 percent of active duty generals or admirals as clients. This firm also employs about 1,000 registered representatives in more than 200 branch offices throughout the United States, as well as locations in Europe and in the Pacific region. The great majority of the firm's sales representatives are former commissioned or noncommissioned military officers.

While sales charges for contractual plans are initially much higher than those of other mutual fund products, the effective sales load—the ratio of the total sales charge paid to the total amount invested—becomes lower as additional investments are made. Over time the effective sales load for a contractual plan will decrease to a level comparable to—or even lower than—other conventional mutual funds with a sales load.[10] As illustrated in Figure 2, if all 180 monthly payments are made under a contractual plan, the effective sales load on the total investment decreases to 3.33 percent

[10]Many mutual funds that are sold with sales charges or loads offer discounts to investors who invest certain amounts of money. As such, if an investor continues to invest in a conventional mutual fund over time, eventually the sales charge percentage of that fund will decrease as the total initial investments reach a certain amount, such as $25,000 or $50,000.

by year 15. However, if a purchaser of one of these plans stops making regular investments earlier, the effective sales charge can be much higher. For example, halting payments after 3 years results in an effective sales load of 17 percent of the amount invested.

**Figure 2: Mutual Fund Sales Load as a Percentage of Investment by Year**




Source: GAO analysis.

At one time, contractual plans were the only way for small investors to invest in mutual funds as in the past many mutual funds required large initial investments, which prevented them from being a viable investment option for many individual investors. However, today, other lower-cost alternatives exist for small investors to begin and maintain investments in mutual funds. For example, many mutual fund companies now allow investors to open a mutual fund account with a small initial investment, such as $1,000, if additional investments—including amounts as low as $50 per month—are made through automatic withdrawals from a bank checking or savings account. According to a recent study by the mutual fund industry association, over 70 percent of the companies offering S&P 500 index mutual funds in 2004 had minimum initial investment amounts

of $1,000 or less, with 9 having minimum investment amounts of $250 or less.[11] Securities regulators saw the wide availability of such products as the reason that contractual plans were rarely being offered to most investors. Another alternative investment option available to service members since 2002 is the government-provided TSP. Comparable to 401(k) retirement plans available from private employers, service members can currently invest up to 10 percent of their gross pay into TSP without paying any sales charge. The various funds offered as part of TSP also have much lower operating expenses than other mutual funds, including those being offered as contractual plans. Service members could also choose to invest as many other investors do in mutual funds offered by companies that do not charge any sales load. Called no-load funds, these are available from some of the largest mutual fund companies over the telephone, the Internet, or by mail.

Although contractual plans can provide benefits to those holding them for long periods, many service members were not making the expected payments and thus ended up paying more than had they invested in other alternatively available products. Given military members' frequent moves and with many leaving the service after a few years, regulators found that most service members were not investing in their plans for the entire term. For example, SEC and NASD found that only 43 percent of the clients that purchased plans between 1980 and 1987 from the broker-dealer that was the largest marketer of contractual plans had completed the full 15 years required under the contract—with many service members ceasing their payments after about 3 years and thus effectively having paid sales loads of 17 percent on their investment. Regulators found that customers of the other broker-dealers marketing these plans were similarly or even less successfully making all of the payments expected under the plan—for example, at one firm only 10 percent of customers had made payments for a full 15 years.

Contractual plans have been associated with sales practice abuses for decades. Concerns about excessive sales charges and other abuses involving these products during the 1930s provided the impetus for provisions in the Investment Company Act of 1940 that limited the amounts that purchasers of contractual plans could be charged. Additional

[11]The study identified 98 companies offering S&P 500 index funds. See Investment Company Institute, "Are S&P 500 Index Mutual Funds Commodities?" *Perspective*, Vol. 11, No. 3 (August 2005).

concerns involving contractual plans during the 1950s and 1960s also led Congress to amend the Act in 1970 to further limit the maximum sales charges and to provide a period in which purchasers could obtain refunds of their investment. Firms marketing contractual plans have again been accused of inappropriate sales practices. In December 2004, SEC and NASD sanctioned the largest broker-dealer marketing these plans to service members after alleging that the firm's marketing materials were misleading. For example, according to the regulators, the firm's marketing materials allegedly included various misleading comparisons of contractual plans to other mutual funds, including characterizing non-contractual funds as attracting only speculators, and erroneously stating that withdrawals by investors in other funds force the managers of those funds to sell stocks. The regulators also alleged that the firm's materials did not present the low-cost TSP as a viable alternative to their contractual plans. This firm agreed to pay a total of about $12 million and has voluntarily discontinued sales of contractual plan products. About $8 million of the total money paid by this firm is to be used to fund financial education efforts for military members that are being developed and administered by NASD. Regulatory examinations of the other four smaller broker-dealers that continue to sell contractual plans are continuing.

Given the longstanding history of sales-practice abuses associated with the contractual plans and the availability of viable alternative investments, we believe that Congress should act to ban the further sale of contractual plans. The bills currently under consideration in the Congress include language that would amend the Investment Company Act of 1940 to render sales of such plans illegal, thereby removing from the market a product that appears to have little need to continue to exist.[12]

[12]S. 418, Sec. 3, and H.R. 458, Sec. 102.

## Lack of DOD Complaint Sharing Hampered Regulators' Ability to Identify Problems Involving Sales to Military Members

Additional actions by Congress, DOD, and regulators also appear warranted to improve the effectiveness of insurance and securities regulators in overseeing sales of financial products to military members. As we reported, the ability of insurance and securities regulators to identify problems involving sales to military members was hampered because DOD personnel were not generally sharing service member concerns and complaints. In addition to conducting routine examinations, insurance and securities regulators use complaints from financial firms' customers as an indicator that problems involving particular products, or the practices of particular firms, exist. For example, state insurance regulators conduct various types of reviews of the insurance companies they oversee, including reviews focusing on insurance companies' financial soundness. Regulators in some states also review some aspects of insurance product sales as part of market conduct examinations that may involve reviews of a range of company practices, including sales, underwriting, and claims processing and payment. Although some states routinely perform market conduct reviews of the companies they oversee, most states only conduct such investigations when they receive complaints from customers or otherwise obtain information that raises concerns about the activities of an insurance company.

One reason that insurance regulators do not review insurance company sales practices more routinely is that standards requiring that any insurance products sold be appropriate or suitable for the purchaser do not generally exist. As a result, under most state insurance laws, insurance regulators do not have the authority to evaluate whether the product sold to a military member was appropriate or suitable given the customer's needs. State regulators and others have previously attempted to establish suitability standards for insurance products, but these efforts have had limited success. For example, a NAIC working group originally formed to develop suitability standards to apply to all insurance sales instead concluded its efforts by developing standards that applied only to the sale of annuity products to seniors age 65 and over.[13]

To reduce the likelihood that service members will be marketed products inappropriate to their needs, in the report we prepared for this committee, we recommend that Congress act to have insurance regulators work cooperatively with DOD to develop suitability or appropriateness standards that would apply to the sale of financial products to military members. The bills being considered in the U.S. Senate include provisions to have these parties work together to develop

[13]Other organizations have also attempted to develop suitability standards. For example, the Insurance Marketplace Standards Association (IMSA) has developed various standards applicable to insurance companies' marketing practices. IMSA also provides qualification to companies that comply with its marketing practices standards.

such standards.[14] Such standards could ensure that companies offer only products that address actual service member needs for insurance and that take into account service members' itinerant lifestyles and income levels. Having such standards could also provide protection for service members that are located in overseas installations not directly overseen by state regulators.

## Securities Regulators Also Hampered by Lack of Complaints Involving Military Members

Similarly, the ability of SEC and NASD to identify problems involving sales by broker-dealers to military members was also hampered by the lack of complaints from DOD and for other reasons. For example, previous SEC and NASD examinations of the largest marketer of contractual plans had not identified any significant problems. However, staff from these organizations told us that identifying the problems involving the sale of this product was made more difficult because neither of the regulators had previously received any complaints about the firm from service members. The securities regulators' ability to detect problems was also hampered by the lack of standardized data on the extent to which customers were completing contractual plans. For example, SEC examiners had obtained data from the largest broker-dealer that purported to show that the persistency rate for the contractual plans—which represented the proportion of plans that were still open—was over 80 percent for the previous 3 years. However, after press reports appeared, NASD and SEC examiners reviewing this firm's operations found that the firm maintained various sets of data on its customers' activity. However, these various sets did not always include all customers' information, which made regulators' efforts to definitively determine the extent to which this firm's customers were continuing to make payments and successfully completing their plans more difficult. By further analyzing the data, the regulators determined that, by excluding any customer whose account remained open but had not made any payments in the last year, the actual extent to which this broker-dealer's customers were successfully completing their contractual plans was only 43 percent. As a result, the report we prepared for this committee recommends that, if contractual plans continue to be sold, SEC and NASD should consider ways (such as through revised examination procedures or recordkeeping rules) to ensure that they obtain better information on the extent to which broker-dealer customers are successfully making their payments.

[14]S. 418, Sec. 9, and H.R. 458, Sec. 108.

## DOD Acting to Improve Sharing with Financial Regulators but Not All Efforts Complete

DOD has also taken some actions to address potentially problematic sales of financial products to service members, although it does not currently share all relevant information with financial regulators. A primary way that DOD attempts to protect service members from inappropriate sales is through its directive on commercial solicitation on military installations.[15] DOD staff within the Office of the Under Secretary of Defense for Personnel and Readiness are revising this directive and, in April 2005, sought public comments on a revised version that incorporates new requirements. For example, the revised directive would expressly prohibit insurance products from being sold as investments. The draft of the revised solicitation directive includes provisions that would also require installation personnel to report all instances in which they ban or suspend the solicitation privileges of any companies or individuals selling financial products to the Principal Deputy Under Secretary of Defense for Personnel and Readiness. In our June 2005 report, we recommended that DOD create a database of all violations of its solicitation policy. DOD has collected and posted some of this information to a web site available to its personnel and others. The bills under consideration in the Senate would further require DOD to promptly notify insurance and securities regulators of those individuals or companies whose solicitation privileges have been suspended, limited, or revoked by DOD installations.[16] In our June 2005 report, we also identified various improvements that DOD has agreed to make to its oversight of insurance purchasers by military members, including the regulations governing the pay allotment process. We summarize these findings and DOD's proposed improvements in appendix I of this statement.

Although DOD personnel had not routinely shared service member complaints with financial regulators in the past, DOD officials have told us that they intend to require their personnel to report more of this type of information to regulators. Under the current solicitation policy directive, DOD personnel are not required to share information relating to service member concerns or complaints with other parties, and the revised draft that was published for comment also lacked any provisions relating to such information. In addition, when we issued our June 2005 report on DOD's insurance solicitation oversight, DOD was reluctant to provide information to regulators beyond indicating that DOD installations had suspended or revoked a given firm's or individual's solicitation privileges or that the violations involved the eligibility of the agent to hold a State license or meet

[15] DOD Directive 1344.7, *Personal Commercial Solicitation on DOD Installations* (Feb. 13, 1986).

[16] S. 418, Sec. 11, and H.R. 458, Sec. 110.

other regulatory requirements.[17] However, staff in the office that oversees the policy directive told us more recently that they intend to specifically require in the new directive that base personnel report to financial regulators any service member concerns or complaints that relate to the quality of the financial products offered to them or regarding the appropriateness of the practices used to market these products. DOD has not, as of yet, issued this new directive. To ensure that financial regulators have critical information that they need to identify problematic products and sales practices, the report we prepared for this committee recommends that DOD issue a revised DOD solicitation policy directive that would require that information on service member complaints related to financial product sales be provided to relevant state and federal financial regulators.

DOD and financial regulators have also worked together to increase education for military members. For example, NAIC and DOD personnel have worked to together to develop a brochure that can be distributed to service members that describes insurance products and lists the state regulatory organizations to contact if they have concerns. In addition, NASD was cooperated with DOD personnel as part of developing the education campaign that is being planned using the money from the broker-dealer contractual plan settlement.

However, DOD has not acted to fully address potential barriers to increased sharing with financial regulators. For example, securities regulatory staff told us that while they were conducting their investigations of contractual plan sales, personnel at some DOD installations were reluctant to share any information involving specific service members for various reasons. According to these regulators, the installation personnel cited military privacy regulations and the restrictions that arise from attorney-client privilege if the service member was being assisted by military legal counsel. According to the director of the DOD office responsible for administering the solicitation policy, such issues can affect their ability to share information with entities outside the military. However, he explained that DOD has researched these legal issues and now believe that they can share information that is deemed to be necessary for the official needs of the requesting organization, including financial regulators. This DOD official also acknowledged that more coordination could be done to ensure that both military

[17] In response to our June 2005 report (GAO-05-696), DOD also concurred with several other recommendations we made, including agreeing to clarify the policy in the revised solicitation directive relating to the "cooling off" period before processing allotments for insurance, improving its database of insurance allotments, and reminding all installations of the policies related to initiating or changing allotments. Our findings on these issues are discussed in appendix 1.

installation personnel and financial regulatory staff understand how additional sharing could appropriately occur

To ensure that financial regulators have critical information that they need to identify problematic products and sales practices, the report we prepared for this committee recommends that Congress direct DOD to develop mechanisms to overcome any barriers and coordinate with its installation personnel and with financial regulators on ways to share additional information about problematic financial firm practices and service member concerns. Our report further recommends that insurance regulators, SEC, and NASD designate specific staff that would receive complaints from DOD and conduct outreach with military installations to proactively learn of issues or concerns involving product sales.

Another concern over whether military members are adequately protected from inappropriate sales stems from uncertainty over financial regulators' jurisdiction on U.S. military installations. Although most of the insurance and securities regulators we contacted believed they had jurisdiction over the sales of financial products on military installations, some regulators expressed uncertainty over their authority to regulate sales on military installations, where the federal government may have "legislative jurisdiction."[18] For example, a Texas insurance department official told us that he had trouble getting access to complaints information at a military installation because installation personnel questioned his authority to request such information. As part of the work on DOD's oversight of insurance sales that we reported on in June 2005, we surveyed the various state and territorial insurance commissioners.[19] Of those that responded to the question regarding whether they had authority over sales of life insurance on military installations, four commissioners indicated that they did not have such authority. State insurance regulators also noted they lack jurisdiction over sales taking place outside the United States at overseas installations. At least one state securities regulator responded to a North American Securities Administrators Association survey that it did not have adequate authority over sales taking place on military installations.

[18]When used in connection with an area of land, the term "legislative jurisdiction" means the authority to legislate and to exercise executive and judicial powers within that area. The federal government holds land under varying degrees of legislative jurisdiction, including "exclusive" legislative jurisdiction, where the state's ability to enforce its laws and regulations is extremely limited. The type of existing legislative jurisdiction over military installations may vary depending on when and how specific tracts of land were acquired.

[19]GAO 05-696.

As a result, the report that we prepared for this committee also recommends that Congress consider acting to clarify the jurisdiction of state regulators over sales of financial products on military installations. Of the legislation under consideration in the Congress, the bill that passed the House of Representatives includes language stating that any state law, regulation, or order pertaining to the regulation of insurance or securities offers and sales are generally applicable to any such activities conducted on Federal land or facilities in the United States and abroad, including military installations. The version introduced in the U.S. Senate includes similar language but would only apply to insurance activities.[20]

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Mr. Chairman, this concludes my prepared statement and I would be happy to respond to questions you or other members of the Committee many have.

## GAO Contacts and Acknowledgements

For further information regarding this testimony, please contact Richard J. Hillman (202) 512-8678. In addition, others making key contributions to this statement included Cody Goebel, Assistant Director; Jack Edwards, Gwenetta Blackwell-Greer; Tania Calhoun; Barry Kirby; and Josephine Perez.

[20]S. 418, Sec. 6(a), and H.R. 458, Sec. 105(a).

# Appendix I: Additional Actions Needed to Improve Oversight of Pay Allotments for Insurance for Military Members

As a result of a report we issued in June 2005, the Department of Defense (DOD) has agreed with our recommendations to improve aspects of its oversight of insurance purchases by military members. [1] At the request of the chairs of the House Committee on Government Reform and House Committee on Armed Services as well as various other members of the House of Representatives, we reviewed DOD's procedures to oversee the sale of insurance products to military members, including the procedures used to process pay deduction allotments to pay for insurance products.

Based on the work we conducted, we determined that DOD was not able to monitor the extent to which service members were purchasing supplement insurance because of problems with its personnel pay databases. Pay information for service members is maintained by the Defense Finance and Accounting Service (DFAS) in separate databases for the different military services. However, we were not able, even with DFAS assistance, to use information from these databases to reliably determine the extent to which service members had purchased additional insurance. For example, the codes in the databases used to identify an insurance company are not the same for all services. Further, DOD and service regulations permit the use of at least seven different allotment forms, but not all of these forms explicityly identify which allotments are for supplemental life insurance.

A major cause of these database-related problems is DOD's systems supporting service members' pay, which we had previously found unreliable.[2] While a significant system enhancement project is under way to improve the administration of military pay, DOD is likely to continue operating with existing system constraints for several years. The continued use of forms that do not require information and coding specific to supplemental life insurance could cause allotment data to continue to be unreliable for oversight purposes.

The absence of accurate data on the extent to which service members are purchasing supplemental life insurance limits the ability of DOD policy officials and installation solicitation coordinators to oversee such sales and ensure that all relevant DOD policies are being followed. For example, the lack of accurate data prevents DOD personnel from readily identifying whether service members at a

[1] GAO 05-696.

[2] See GAO, *DOD Systems Modernization: Management of Integrated Military Human Capital Program Needs Additional Improvement*, GAO-05-189 (Washington, D.C.: Feb. 11, 2005), and GAO, *Military Pay Army National Guard Personnel Mobilized to Active Duty Experienced Significant Pay Problems*, GAO-04-89 (Washington, D.C.: Nov. 13, 2003).

particular installation have submitted an unusually large number of new allotments for supplemental life insurance during a short period, which could indicate that a mass solicitation to recruits or trainees has occurred in violation of DOD's personal commercial solicitation policy directive.[3]

As a result, our June 2005 report recommended that DOD determine what current and future modifications should be made to the regulations, forms, and procedures used to initiate and electronically capture supplemental life insurance allotments so that more useable data are available to the DOD, service, and installation offices responsible for overseeing supplemental life insurance solicitation. In its comments on a draft of our report, DOD concurred with this recommendation and stated that the department will consider our proposed changes for a future enhancement of their pay system and will review the regulations and forms to determine what further modification should be made.

Based on our work, we also found that weaknesses in DOD's regulations and forms prevented it from determining the extent to which its personnel adhere to allotment regulations. For junior enlisted service members (pay grades E-1 to E-3), the DOD directive on personal commercial solicitation requires that at least 7 days elapse before the allotment is to be processed to allow these members to receive counseling about the purchase of the supplemental life insurance. However, contrary to the regulation, we found that some DOD financial personnel were accepting allotment forms to start supplemental life insurance without verifying that a cooling-off period had elapsed.[4] Currently, the allotment forms that service members use to start supplemental life insurance do not require certification that the required cooling-off period and, possibly, counseling have occurred. The absence of this information from allotment forms prevents finance personnel from readily determining whether the 7 days have elapsed before they certify the allotment. In addition, ambiguities in the language of the solicitation policy directive may have also led to improper allotment processing. For example, the directive was not clear as to whether the counseling is required or optional during the cooling-off period. In addition, the directive and the standard allotment forms do not contain procedures for documenting whether the counseling took place.

[3]DOD Directive 1344.7.

[4]This cooling off period can be waived. For example, the directive states that the purchaser's commanding officer may grant a waiver of this requirement for good cause, such as the purchaser's imminent permanent change of station.

To ensure better compliance with the directive, our June 2005 report recommended that DOD clarify the requirements relating to the cooling-off period in its upcoming revision to the solicitation policy directive, and thereby eliminate the ambiguities about its requirements. In its comments on a draft of our report, DOD concurred with this recommendation and stated that it had identified an additional ambiguity in the current revised directive regarding who is responsible for monitoring and enforcing the cooling-off period for supplemental life insurance purchases. It indicates that the proposed revision to the directive will address these issues.

We also found DOD personnel were not consistently complying with regulations relating to ensuring that allotments were appropriately authorized. According to DOD's Financial Management Regulation, establishment of, discontinuance of, or changes to existing allotments for supplemental life insurance are to be based on a written request by a service member or someone with a special power of attorney on behalf of the service member.[5] However, DOD personnel and insurance agents indicated that some offices accepted allotment forms personally submitted by insurance agents or through the mail with only the signature on the form serving as proof that the service member initiated the allotment. For example, finance office personnel at Naval Station Great Lakes said that about half of all insurance allotment forms submitted to and processed by their office came from insurance agents. In addition, we reported that a life insurance agent was alleged to have submitted allotment forms at Fort Bragg for service members who later said they had not wanted the policies for which they were paying. Finance personnel said they accepted allotment forms in this manner to ensure that polices start promptly, but starting allotments without service members' awareness can negatively affect members' finances and their unit's morale and readiness.

To ensure that allotments are properly authorized, our June 2005 report recommended that DOD issue a message to all finance offices and DFAS offices that process allotments for supplemental life insurance to remind personnel that DOD's Financial Management Regulation indicates that only service members or their designated representatives with special power of attorney for the prescribed

[5]DOD, Financial Management Regulation 7000.14-R, Vol. 7A, Chapter 41, sec. 410801. This regulation allows most financial allotments to be established though MyPay, DOD's automated payroll program. MyPay allows service members to start, stop, or change allotments with financial institutions when the funds are directed to be sent to a savings or checking account. MyPay is not intended to be used for allotments to purchase supplemental life insurance. Use of MyPay to establish a supplemental insurance allotment makes it impossible for installation officials to monitor or enforce the proper use of insurance allotments and other parts of the on-installation personal commercial solicitation requirements.

purpose are authorized to start, stop, or modify financial allotments. In its comments on a draft of our report, DOD concurred with this recommendation and stated that it will issue such a statement.

## PREPARED STATEMENT OF JOHN M. MOLINO

DEPUTY UNDER SECRETARY OF DEFENSE, MILITARY COMMUNITY & FAMILY POLICY
U.S. DEPARTMENT OF DEFENSE

NOVEMBER 17, 2005

Mr. Chairman, Members of this distinguished Committee, thank you for the opportunity to be here today and for your interest in protecting the financial well-being of the men and women who serve in our armed forces.

Allow me to provide the Committee with historical information on the personal commercial solicitation issue, and to address what the Department has done, and intends to do to improve commercial solicitation oversight and enforcement. I will focus on the sale of supplemental life insurance and financial products on Department of Defense (DoD) installations.

Servicemembers have long been seen as targets for charlatans, con men and others who seek to steal their money with deals "to good to be true," or presented under false pretenses. Why is this?

Servicemembers are typically young and inexperienced. They are often motivated by idealism and cannot imagine that their fellow citizens and, in some cases, their senior NCO's, officers, and military retirees would take advantage of them.

They are often earning a steady paycheck for the first time and, though their pay will never make them rich, it is often far more money than they have ever laid their hands on in their lives. Those who enlisted are motivated to serve. They also tend to be concerned about the future—providing for themselves and their families.

The confluence of these otherwise noble characteristics makes servicemembers subject to swindlers and fast-talking salesmen and women.

When we permit someone to sell a product to some degree we provide the appearance of an endorsement of that product and the behavior of the salesperson.

As you know, members of the military have the opportunity to purchase up to $400,000 worth of term life for a reasonable premium of $26 per month. For many—indeed most—military members, $400,000 is a sufficient amount of insurance, especially if combined with Thrift Savings Plan (TSP) participation or another savings plan. I will speak more of our Financial Readiness program later. For now, let me say that a better informed Servicemember/consumer will be able to make wiser decisions about the products he or she buys.

We must provide a degree of protection that ensures we do not facilitate deceptive practices on the installation. We also must provide training and education that better equips our members and their spouses to a "smell a rat" outside the gate.

The Department's concern with the sale of insurance and investment products on DoD installations dates back to the Vietnam War era. At that time, problems with private sector associations using their quasi-military status to sell life insurance products led to establishment of the first DoD personal commercial solicitation policies. These included DoD Directive 1344.7, *"Personal Commercial Affairs,"* dated July 1, 1969 and DoD Directive 1344.1, *"Solicitation and Sale of Insurance on Department of Defense Installations,"* dated August 31, 1977. These directives were later combined into our current DoD Directive 1344.7, *"Personal Commercial Solicitation on DoD Installations,"* dated February 13, 1986. Though these directives established important rules and prohibited practices concerning on-base solicitation, there is ample evidence to prove they have not been easily or consistently enforced.

*1996 USAREUR IG Report:* In 1996, the US Army Europe (USAREUR) Inspector General (IG) investigated insurance solicitation activities by the Noncommissioned Officers Association (NCOA) and Academy Life Insurance Company. The IG found:

- Senior NCO's (NCOA members) improperly used their authority to require soldiers to attend assemblies/meetings for the purpose of signing up new NCOA member in violation of Army USAREUR Regulations.
- NCOA and Academy Life improperly conducted commercial solicitation during duty hours.
- NCOA improperly received preferential treatment over other nonprofit organizations in violation of Army and USAREUR regulations.
- The chain of command improperly pressured subordinates to join NCOA.
- NCOA/Academy Life improperly conducted deceptive solicitation practices in violation of DoD Directive 1344.7 and Army and USAREUR Regulations.
- NCOA/Academy Life improperly used the military postal system for commercial or business purposes in violation of USAREUR Regulations.

In September 1998, as a result of USAREUR IG investigation, Academy Life and its agents were barred from conducting commercial activities on DoD installations worldwide for a period of 3 years.

*1999 DoD IG Report:* In January 1998, the Department of Defense Inspector General (DoD IG) was asked to evaluate the Department's enforcement of personal commercial solicitation policy. The DoD IG visited 11 installations and issued a report in March 1999. The IG found policy violations at all 11 installations. The DoD IG found:

- Quasi-military associations failed to disclose their relationship to insurance companies and in some cases, these associations were allowed to make group presentations to military personnel in order to collect personal information for follow-on solicitation.
- Insurance agents were permitted to make "financial education" presentations at four installations in direct violation of Department policy.
- The Services failed to provide sufficient training on insurance to servicemembers.
- Commercial sponsorship, where funding, goods, or services is offered to installation Morale, Welfare, and Recreation activities in return for public recognition or advertising promotions, was being used to foster commercial solicitation.
- Administrative personnel at two Army installations accepted allotments forms directly from insurance agents, rather than requiring they be submitted by the military member.

The DoD IG recommended the Assistant Secretary of Defense (Force Management Policy) establish a task force to:

- Develop consistent controls to administer and enforce the policies regarding commercial solicitation process.
- Develop the approval and oversight procedures when allowing outside organization personnel from military associations to conduct financial training.

*Cuthbert Report:* On May 15, 2000, Brigadier General Thomas Cuthbert, U.S. Army (Ret), an employee of the Science Applications International Corporation (SAIC) on contract with the Department, issued a report on solicitation practices on DoD Installations. The Cuthbert Report validated the findings of the DoD IG Report and highlighted 30 years of deceptive commercial solicitation practices. The Cuthbert Report found:

- DoD policies are routinely violated.
- DoD allotment systems facilitate the violation of insurance solicitation policies.
- A coercive and high pressure sales environment remains in effect.
- Deceptive insurance sales practices continue unabated.
- Deceptive and coercive solicitation has a clear and present adverse effect on morale, discipline, and unit integrity.
- Current personal financial education programs are inadequate.
- Insurance companies have unlawfully retained insurance premiums from cancelled allotments.
- State insurance regulators do not effectively protect military consumers.
- On-base insurance sales provide no value added to war fighting capacity.

The Cuthbert Report recommended:

- Eliminate on-base insurance solicitation.
- Improve consumer protection surrounding the allotment system.
- Conduct an inquiry into the disposition of unlawfully withheld allotment payments.
- Improve personal finance training in all enlisted schools.
- Establish minimum standards for all personal finance training conducted by non-DoD personnel.

*DoD Commercial Solicitation Working Group:* In response to the DoD IG and Cuthbert reports, the Assistant Secretary of Defense (Force Management Policy) established a DoD commercial solicitation working group in January 2001. The group recommended:

- Establish commercial solicitation points of contact for each military service.
- Establish new policy to control third-party financial counseling.
- Establish new policy to limit the use of commercial sponsorship to foster commercial solicitation.

*2001 DoD IG Report:* In response to the Cuthbert Report finding regarding insurance premiums being unlawfully retained by insurance companies following cancellation of a policy, the Department requested the DoD IG conduct an audit on insurance allotment premium refund processing procedures. The IG's report found:

Four Defense Finance and Accounting Service (DFAS) sites did not consistently process insurance company requests to cancel allotments and one DFAS site would not accept returned allotments.

In response, DFAS issued standardized guidance requiring the different sites to stop allotments when a properly documented request is received from an insurance company and to accept returned allotment payments.

*Financial Education Policy:* In April 2002, the Under Secretary of Defense (Personnel and Readiness), issued a policy memorandum that established parameters for nongovernmental organizations to provide financial education training to servicemembers. The policy directed that any participating non-Federal entity must be qualified as a 501(c)(3) nonprofit organization and that the training be approved by a presidentialy appointed, Senate-confirmed civilian official of the military department. The policy memo also reemphasized the existing prohibition against agents of insurance or financial product companies presenting financial training.

*Initial Revision of DoD Directive 1344.7:* After nearly a year of revision and information coordination, the Department forwarded proposed changes to DoD Directive 1344.7 to the military services for coordination and comment. Proposed policy changes included a requirement for junior enlisted personnel to obtain approval from their chain of command to purchase supplemental commercial life insurance. The insurance industry strongly opposed this proposed change and sought the involvement of Congress to block the reform effort. In November 2003, Public Law 108–136, Sec. 586, required the Department provide Congress 30 days notification prior to implementing any changes to DoD personal commercial solicitation policy. To try to maintain the momentum, the Department also agreed to conduct two public forums. The first, to obtain public comment on existing DoD personal commercial solicitation policy, and the second, to obtain comment on any proposed changes.

*Financial Readiness Campaign:* In May 2003, the Department, in cooperation with the Department of the Treasury and the Securities and Exchange Commission, initiated a DoD Financial Readiness Campaign. The campaign established agreements with Federal agencies and nonprofit financial education organizations. Through the expertise and donated resources of these Federal agencies and nonprofit organizations, the Department has extended the capability of the Military Services to train and counsel servicemembers and their families on a range of personal financial issues, to include insurance and financial products. We have included a list of over 20 of the partner organizations on our quality of life portal: *www.militaryhomefront.dod.mil,* under "Financial Readiness." Examples of these collaborations include: The American Savings Education Council, which has provided over 57 public service announcements to the Armed Forces Radio and Television Service for broadcast overseas, and the InCharge Institute, which in collaboration with the National Military Family Association, has distributed 250,000 copies of their *Military Money* Magazine (developed for the military spouse) through Defense Commissaries and other high traffic areas on military installations.

*First Public Forum:* The first meeting to seek public comment on existing DoD personal commercial solicitation policy was held on August 22, 2003. Fifty-nine persons, mostly representatives from insurance and financial services companies, submitted comments. The primary themes of comments received were:

- DoD's personal commercial solicitation policy is basically sound but needs to be better enforced.
- DoD should not regulate insurance and financial products because that is a State and Federal regulator responsibility.

*Commercial Sponsorship Policy Revision:* In March 2004, the Principal Deputy Under Secretary of Defense (Personnel and Readiness) issued new MWR program commercial sponsorship policy. An April 2004, policy memorandum directed the military departments to decline commercial sponsorship offers that do not reflect favorably upon DoD. In addition, this memorandum directed the military departments to ensure commercial sponsors do not use their sponsorship to obtain personal contact information for future solicitation without the written consent of the person to be solicited.

*First GAO Audit:* In March 2004, the Chairmen of the House Government Reform Committee and the House Armed Services Committee requested the Government Accountability Office examine DoD and military services policies and procedures for the marketing and sale of life insurance policies to military personnel and the processing of financial allotments for military personnel. This audit was requested in response to insurance industry complaints, which alleged officials at Fort Lewis and Fort Bragg had deliberately failed to process hundreds of life insurance allotments and military personnel were being directed to cancel their supplemental commercial life insurance. During this audit, the GAO conducted site visits at Fort Lewis, Washington, Naval Training Center Great Lakes, Illinois, Marine Corps Base Camp Pendleton, California, Fort Bragg, North Carolina, Lackland Air Force Base, Texas, and Fort Campbell, Kentucky. On August 2004, Public Law 108–287, Sec. 8133, pro-

hibited the Department from amending or changing its personal commercial solicitation policies until 90-days after the GAO issued their final report. In its final report, issued on June 29, 2005, the GAO could not substantiate the original allegations pertaining to Fort Lewis and Fort Bragg, but made three recommendations to improve DoD personal commercial solicitation policy and two recommendations to improve insurance allotment coding and processing. This audit did not examine the suitability of insurance and financial products being sold primarily to military personnel or how they were sold. The Department partially concurred with the GAO's first two recommendations and concurred with the other three. The first partial concurrence concerned a GAO recommendation that the department develop and maintain a DoD-wide searchable database to record all violations of DoD personal commercial solicitation policy. The Department has developed and maintains a current list of companies and agents that are barred from soliciting on an installation and believes that this list is more useful and appropriate than the one the GAO recommends. In the second partial concurrence, the GAO recommended all violations of DoD solicitation policy involving insurance or financial products be reported to State or Federal regulators. The Department believes only violations that involve licensing, compliance with State or Federal laws or regulations, or that result in the company or agent being barred from an installation, should be reported to regulatory authorities. The Departments believes reporting only actionable violations to State and Federal regulators will serve everyone's best interests.

*New York Times Investigative Reports:* Beginning in July 2004, *The New York Times* published a series of investigative reports that focused much needed attention on the DoD personal commercial solicitation issue. Among other things, the reports highlighted DoD policy violations by several insurance companies soliciting Army trainees at Fort Benning, Georgia and potentially costly periodic payment plans marketed by First Command Financial Planning, Inc., mostly to military personnel. The Department took these reports very seriously. I asked the Assistant Secretary of the Army (Human Resources) to advise my office of actions taken at Fort Benning and to recommend whether or not the findings warranted Service-wide or DoD-wide action. Fort Benning has conducted detailed proceedings and has taken decisive action locally. I understand that the Fort Benning commanding general's recommendation for broader actions is currently at Department of the Army headquarters for legal review. In addition, I requested the Military Departments report all documented personal commercial solicitation policy violations that have occurred since January 1, 2000 and to provide quarterly update reports. This information is used maintain a list of insurance and financial product companies and agents currently barred from soliciting on a DoD installations that is posted on our DoD Commanders Page website. Following enforcement action by the National Association of Securities Dealers (NASD) and the Security and Exchange Commission (SEC) against First Command Financial Planning, I met with First Command's President and Chief Executive Officer, who informed me that they have ceased selling, and will no longer sell, periodic payment plans. The Department has collaborated with the National Association of Insurance Commissioners on an educational brochure to assist military personnel considering the purchase of supplemental commercial life insurance. This brochure includes contact numbers for Insurance Commissions in all 50 States and the District of Columbia. The Department's Financial Readiness Campaign is educating our military servicemembers to closely examine products being offered and to seek legal advice before signing contracts. This program is intended to make servicemembers and their spouses better informed, more discriminating consumers.

*Second GAO Audit:* Mr. Chairman, in late 2004, you and the Ranking Member of this Committee requested the Government Accountability Office review the sale of financial products to military members. Specifically, the GAO was asked to "examine the types and variety of financial products" commonly marketed to military members; regulatory oversight by insurance and securities regulators and DoD; the regulatory oversight and consumer protections afforded to military personnel compared to the general public; and how regulators have assessed the suitability of such products. The Department thanks this Committee for its concern, not only in how, where, and when insurance and financial products are being sold to military personnel, but also what kinds of products are being sold. This is the first time the suitability of insurance and financial products sold primarily to military personnel has been examined. This focus is much needed, long overdue, and much appreciated. The recommendations in the GAO's draft report, issued on September 29, 2005, are reasonable and appropriate.

*DoD Instruction on Personal Financial Management Education:* The Miltiary Services have established training for servicemembers on a list of topics that includes insurance, saving, and investing as part of their initial orientation in the

military. DoD Instruction 1342.17 was released in November 2004, providing the first comprehensive policy document describing personal financial education and counseling requirements for servicemembers and their families, to include the already established training being delivered to junior servicemembers. The instruction has given us an opportunity to reinvent this training by requiring junior servicemembers be able to show their competence in applying basic financial principles on a wide range of financial topics, to include insurance and savings. In addition, first time supervisors are to demonstrate their understanding of policies and practices designed to protect junior servicemembers within their command/supervision, to include policies and practices concerning commercial solicitation. We are currently working on the implementation of a strategic plan for Personal Financial Readiness that includes establishing the evaluation tools needed to ensure these important policies are being applied.

*Strategic Plan for Personal Financial Readiness:* As part of the answer to a GAO study on personal financial management programs (GAO–05–638R), the Department has crafted a strategic plan that incorporates the steps to ensure the implementation of DoD Instruction 1342.17, and the resources/capabilities of the Financial Readiness Campaign. A key new component of this strategic plan is the program being developed by the National Association of Securities Dealers (NASD) Foundation. This program, funded through the residual proceeds of the settlement with First Command Financial Services, seeks to give servicemembers and their families confidence to management their financial resources, by gaining their attention through an awareness campaign and providing unbiased educational resources to support their decisionmaking needs. The NASD Foundation program includes the capabilities and resources of several of the existing Financial Readiness Campaign partners, increasing the impact of the overall effort.

*Second Public Forum:* The Department's proposed policy changes were published in the *Federal Register* on April 19, 2005. The substantive changes focused on financial education, oversight, and enforcement. They incorporate the financial education, commercial sponsorship, and violation reporting guidance I mentioned previously. We also include a new commercial solicitation evaluation form designed to make it easier for installations to detect and investigate solicitation policy violations. The Department hosted a second open forum on May 6, 2005, to obtain public comment on the proposed changes. Twelve persons, representing various insurance, financial service, veteran and military fraternal organizations, provided oral comments. In addition, 31 other individuals and organizations submitted written comments by the June 20, 2005 deadline. A total of 79 specific recommendations were received during the second public forum and comment period.

*Proposed Policy Changes:* The Department has carefully considered all 79 recommendations. We have accepted 31 and partially accepted 9 of these recommendations for inclusion in our final policy revision. Many of these additional changes clarify questions of interpretation of existing policy or new policy to cover new technologies. Examples include telecommunications aspects of solicitation, electronic versus paper pay and allotment transactions, and the use of direct deposit versus military pay allotment forms. Other changes include policies to incorporate our responses to the GAO's recommendations and provisions in pending legislation the Department supports and expects will become law. These include solicitation policy violation reporting and recordkeeping and enforcement of the military pay allotment cooling off period. Our proposed final policy is currently being reviewed for legal sufficiency by the DoD General Counsel.

In conclusion, the Department does not intend to prevent honest companies from doing business on DoD installations but we must take prudent steps to protect military members from superfluous products and predatory sales practices. Problems associated with on-base commercial solicitation of military personnel have been ongoing for many years. Prior attempts to implement new policies to improve DoD's oversight and enforcement met with resistance on many fronts. We believe now, with the public's attention and the support of this Committee and the Senate and House Committees on armed services, long overdue changes to protect the financial well-being of military members and their families will finally become reality. Any further delay is unacceptable. Our men and women in uniform, and in harm's way everyday, deserve no less.

## PREPARED STATEMENT OF LORI RICHARDS

DIRECTOR, OFFICE OF COMPLIANCE, INSPECTIONS, AND EXAMINATIONS
U.S. SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 17, 2005

### Introduction and Summary

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am pleased to appear today to testify on behalf of the Securities and Exchange Commission (Commission) to express the Commission's views on the Government Accountability Office's (GAO) report entitled *Financial Product Sales: Actions Needed to Better Protect Military Members* (GAO–06–23). My testimony will address the portion of the report that discusses sales of securities products.

The Commission strongly believes that our servicemen and women must be protected from illegal and abusive practices in the sale of securities. Over the last year, the Commission and its staff have undertaken a comprehensive program to address such practices. Our program has included enforcement activity, extensive examination activity, close coordination with the Department of Defense (DoD) and the National Association of Securities Dealers (NASD), and investor education and other outreach activity. These actions are summarized below, and described in greater detail in this testimony.

- The Commission brought an enforcement action against a broker-dealer, *First Command Financial Planning, Inc.,* that specializes in sales of securities to military personnel. The Commission's enforcement action ordered *First Command* to cease and desist from illegal and abusive practices in the sale of securities, and includes an order to pay $12 million: $5.2 million in restitution to military customers, and the remainder to fund an investor education program for the military administered by the NASD.
- The Commission's examination staff have conducted numerous examinations of broker-dealer firms that sell securities to the military personnel. These examinations have included two separate risk-targeted examination sweeps, one focusing on sales of mutual fund contractual plans, or "periodic payment plans," and the other focusing more generally on sales of securities products to military personnel. These examinations have included on-site reviews of securities firms serving the military market, and visits to sales offices located in military base communities, both in the United States and overseas.
- Commission staff have worked closely with DoD, establishing a regular liaison with the Office of the Secretary of Defense, through which we have shared information and coordinated our examinations. We have also coordinated our efforts with the commands of selected bases. In our work, we have found the DoD and the individual base commands to be open, responsive, and helpful. This coordination is continuing, with DoD providing us with on-going information that we are using to target securities firms for examinations.
- In all of these efforts, Commission staff have worked closely with the NASD. This joint effort included coordination of enforcement activity, examinations, and investor education programs for members of the military.
- Finally, Commission staff in the Office of Investor Education and Assistance have conducted an active investor education initiative targeted toward members of the military. As a charter member of the DoD's *Financial Readiness Campaign,* we assisted in the presentation of financial education programs to the military. Commission staff have already conducted several financial education workshops on military installations. As part of this initiative, Commission staff prepared an article on periodic payment plans for *Military Money,* a not-for-profit publication that is distributed free in the military community. In addition, an online brochure on periodic payment plans is available on our website. Finally, we have also conducted an outreach program to the securities community, with members of the Commission's staff speaking at conferences and in other settings, on the need for securities firms to better protect and serve their military customers.

We strongly agree with the GAO's recommendation that Congress should take legislative action in this area to protect military servicemembers. We recommend that you consider taking steps to address the features of mutual fund contractual plans that make them susceptible to abusive and misleading sales practices and excessive fees. In addition, as noted above, we have already taken action to enhance our information-sharing with DoD.

**Regulation of Broker-Dealers and "Periodic Payment Plans"**

The Commission regulates the sales of securities through, among other things, its regulation of broker-dealers. Broker-dealers operate in a comprehensive regulatory environment. They must: Register with the Commission and comply with the laws and rules governing broker-dealers; become members of the NASD and comply with its rules and oversight; and comply with regulations governing, among other things, their financial responsibility and the protection of customer funds and securities. They must also comply with the antifraud provisions of the Federal securities laws and NASD rules, which, among other things, impose duties of fair dealing and an obligation to recommend securities that are suitable for the customer.[1]

To evaluate compliance with these requirements, the Commission, the NASD, and other self-regulatory organizations conduct examinations of broker-dealers, in which examiners visit broker-dealers, review their books and records, interview their employees, and seek to identify violations of applicable laws or regulations or control weaknesses that could lead to such violations. NASD and other self-regulatory organizations conduct routine examinations of their member firms, and the Commission staff conduct oversight of the SROs' programs, "cause" exams based on a complaint or a tip, and other types of examinations. In recent years, SEC staff have conducted more risk-targeted examination sweeps to quickly identify areas of emerging compliance problems.

To enforce the Federal securities laws, the Commission can bring enforcement actions. In 2004, the Commission brought 141 enforcement actions involving broker-dealers or associated persons, approximately 22 percent of the enforcement actions that it brought in that year. NASD and other self-regulatory organizations also bring disciplinary actions against broker-dealers for violations of their rules.

While there are no formal records that categorize broker-dealers by the types of customers they serve, our work in this area indicates that securities are sold to members of the military by several different types of broker-dealer firms. A small number of broker-dealer firms focus or specialize in selling securities to the military market. These are firms that have dedicated either their entire organization or a significant business line to serving the military market. There are also smaller broker-dealer firms that may have a single office or offices located near military bases in the United States or overseas, and that focus sales efforts to military personnel. Finally, there are also broker-dealer firms that do not focus on sales to military personnel, but may have a single sales branch office located in a military community and may develop a local military clientele. In addition to selling securities, these sales offices may provide a range of other financial services, including insurance, paycheck loans, and tax preparation.

In addition to regulating broker-dealers, the Commission also regulates some of the financial products that have been sold to members of the military. These include a product known as a mutual fund contractual plan, or a "periodic payment plan." This product is governed by the Investment Company Act, which generally defines a periodic payment plan certificate as a security in which an investor makes a long-term series of periodic payments to acquire an interest in a specified unit or fund of securities (Section 2(a)(27) of the Investment Company Act). Most mutual fund contractual plans contemplate that the investor will make periodic monthly payments for 15 or more years. These products contain a high front-end load: Up to half of the investor's payments made in the first 12 months are deducted as a sales load. As a result, if the investor redeems his/her investment before the full term of the contract, the investor would pay an abnormally large sales load on his/her investment. The Investment Company Act imposes various limitations on the sale of these products, including a maximum allowable sales load on the total payments to be made by the investor (9 percent), and the maximum portion of the first 12 monthly installment payments that may be deducted as sales load (50 percent), among other things.

As GAO notes, in the distant past these plans were one of the few means by which smaller investors could make low-dollar investments in mutual funds. Over the years, however, alternative means of making such investments have been developed by fund firms, including both load and no-load funds that accept low initial investments and low periodic or automatic investment plans.[2] These alternatives provide an opportunity for low-dollar investments without the large up-front sales load charged by periodic payment plans. As a result, mutual fund periodic payment plans have ceased to attract large numbers of civilian investors.

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[1] A summary of these duties can be found on the Commission's website. *See www.sec.gov/divisions/marketreg/bdguide.htm.*

[2] A no-load fund charges no sales commissions on share purchases.

Only a small number of such plans are currently available. As of October 2005, there were only 8 financial firms that sponsored periodic payment plans registered with the Commission. These firms have registered a total of 19 plans with current assets of $12 billion, which represents less than two tenths of 1 percent (<0.2 percent) of the assets currently invested in nonmoney market mutual funds. Indeed, many of the registered periodic payment plans are no longer being sold, and even the largest plans have shrunk over the last year (measured by aggregate invested assets).[3] Nonetheless many members of the military have continued to invest in these plans.

**The Commission's Program to Protect the Military from Illegal and Abusive Practices in the Sale of Securities**

In 2004, when potentially abusive sales practices in the sale of securities to military personnel came to the attention of the Commission's staff, Commission staff determined that the military community should be identified as an at-risk group. Following this determination, Commission staff quickly deployed resources from multiple functional programs of the Commission, including enforcement, examinations, and investor education, and initiated a coordinated approach to seek to protect members of the military from abusive sales practices. Each step is described below.

IN THE MATTER OF FIRST COMMAND FINANCIAL PLANNING, INC.

On December 15, 2004, the SEC and NASD instituted enforcement proceedings against *First Command Financial Planning, Inc.,* a registered broker-dealer based in Fort Worth, Texas, whose customer base consisted almost entirely of active-duty and retired U.S. military personnel. In coordinated joint actions, the SEC and NASD alleged that *First Command* used misleading sales materials to offer and sell periodic payment plans. In settlement of these actions, *First Command* agreed to pay $12 million in disgorgement and prejudgment interest to be used to reimburse certain customers and to fund an NASD investor-education program for members of the U.S. military and their families. In November 2004, *First Command* stopped selling periodic payment plans altogether. As the Commission's enforcement order entered against *First Command* states, the firm maintained sales offices near U.S. military bases worldwide and claimed that its customers included approximately 40 percent of the active-duty general officers and approximately one-third of the commissioned officers. The vast majority of *First Command's* sales agents were retired military officers. This firm was responsible for approximately 90 percent of all sales of periodic payment plans.

Like other periodic payment plans, and as described in the Commission's order, the investments sold by First Command allowed investors to accumulate shares in one of five mutual funds by making fixed monthly contributions—typically ranging from $100 to $500—over a period of at least 15 years. Each contractual plan imposed a unique sales charge, or "load," which equaled 50 percent of the plan's first 12 monthly payments with no sales load thereafter. If the investor made the plan's scheduled 180 payments over the 15-year period, the effective sales load worked out to be approximately 3.3 percent. On the other hand, if the investor failed to make all of the scheduled payments, the effective sales load could be substantially higher. The Commission's order further stated that historically, approximately 43 percent of *First Command's* customers made at least 180 scheduled payments. Many of the *First Command* customers were unable to complete the 180 payments and, consequently, many of them paid loads substantially higher than 5.2 percent, the approximate average sales load for all conventional-load equity mutual funds in 2003. In the worst case, those who discontinued payments after 1 year paid a 50 percent sales load.

The Commission's order against *First Command* contained findings that, since at least January 1999, the firm offered and sold contractual plans using carefully worded sales scripts that made misleading comparisons between the periodic payment plans and other mutual-fund investments. For example, *First Command* claimed that periodic payment plans are the only funds that are designed for dollar-cost averaging investors, that no-load funds were primarily for "speculative" investors, and that transactions by speculative investors reduced the opportunity for the no-load fund's manager to make opportune investments for the fund. In reality,

[3] During their most recently completed fiscal years, the six largest periodic payment plans measured by asset size had aggregate gross sales of $931 million and redemptions of $950 million; resulting in net redemptions of $19 million. Of these six, some of the smaller plans experienced net sales, but the amount of those sales was insufficient to offset the redemptions at the larger plans.

many long-term investors invest in no-load funds, and many no-load funds maintain dollar-cost-averaging programs allowing investors to make relatively small periodic contributions. The Commission found that *First Command's* sales materials also contained misleading statements and omissions concerning the costs of no-load funds, and the availability of the Thrift Savings Plan, the Federal Government-sponsored retirement savings and investment plan, which offers military investors many of the features of a contractual plan, but at a lower cost. The Commission further found that, in light of the relatively low completion rate in its periodic payment plans, *First Command* misrepresented the efficacy of the upfront load in ensuring that investors remain committed to the contractual plan. The NASD's action, filed on the same day, contained similar findings.

As part of its settlement with the Commission and NASD, *First Command* agreed to compensate military investors who purchased and terminated their plans during a specified period who paid an effective sales load of greater than 5 percent. By prematurely terminating their plans, these investors incurred effective sales loads well above the average load charged by conventional-load equity mutual funds.

In addition to the $12 million payment, the Commission ordered *First Command* to cease and desist from committing or causing violations of certain of the antifraud provisions of the Federal securities laws. The Commission and NASD orders also directed *First Command* to comply with certain undertakings, including hiring an independent consultant to review and make recommendations concerning the adequacy of *First Command's* sales scripts, sales training systems and procedures, and supervisory systems and procedures.

As of November 8, 2005, *First Command* had paid $6.81 million to the military investor-education fund operated by the NASD and expects to pay approximately $37,000 more into the fund by the end of the year, depending on the final outcome of the investor-reimbursement process. As of November 2, 2005, *First Command* had reimbursed approximately $4.3 million to approximately 10,000 military investors that were harmed as a result of the misconduct. The independent consultant overseeing the distribution advises that his firm is in the process of tracking down current addresses for approximately 3,500 additional military investors to pay out approximately $860,000 that remains undistributed in the settlement fund. It is expected that the reimbursement process will be completed by the end of the year.

Working together, the SEC and NASD brought an end to misleading sales practices affecting approximately 90 percent of the contractual plans sold to U.S. military families, provided for reimbursement to harmed military investors, and obtained significant funding for military investor-education programs.

EXAMINATION SWEEPS FOCUSING ON SALES TO MILITARY PERSONNEL

Following indications of sales practice problems involving sales to military personnel, the Commission's examination staff initiated targeted examination sweeps of certain broker-dealers. First, the Commission staff initiated an examination sweep of broker-dealers (in addition to *First Command*) that sell periodic payment plans. Second, the Commission staff initiated an examination sweep of broker-dealers that sell other securities products to members of the military. Each examination sweep is described generally below. In light of the confidential nature of SEC examinations, the SEC has not discussed publicly either the examinations or the names of the firms.

*Examinations of Broker-Dealers That Sell Periodic Payment Plans*

In addition to *First Command,* a small number of other broker-dealers sell periodic payment plans to investors. SEC staff examined four of these firms that sold significant amounts of contractual plans. The three largest of the four firms examined were found to sell periodic payment plans exclusively to the military community. In combination with *First Command's* sales to the military community, the staff believes that our reviews of these products may have captured as much as 95 percent of the sales of periodic payment plans sold to the military community. Like *First Command,* these firms have discontinued sales of contractual plans.

Unlike *First Command,* these three firms generally sold contractual plans to lower-ranking enlisted military members. These contractual plans also called for a 50 percent load paid out in the first 12 installments, with no additional load after that, and consisted of at least 120 payments to be made monthly over 10 years. Although the examinations of these firms did not reveal the systemic misrepresentation present in the *First Command* case, they did show that very few low-ranking enlisted members made at least 120 payments. At one firm, fewer than 10 percent completed their plans. On average, low-ranking enlisted members paid loads greater than 10 percent—significantly higher than they would have paid if they had purchased mutual-fund shares with a conventional load.

The high incidence of incomplete plans discovered in these examinations raised concerns that these firms may have routinely recommended contractual plans to investors that required monthly installments in amounts greater than the investor could reasonably afford. Under NASD Conduct Rule 2310, a brokerage firm is required to have reasonable grounds for believing that its recommendation is suitable for its customer in light of the customer's financial situation, among other things. Accordingly, the Commission's staff has provided its examination results relating to these three firms to the NASD.

*Examinations of Broker-Dealers That Sell Other Securities Products to Military Personnel*

As noted above, following indications from the *First Command* matter that members of the military may be at risk due to abusive or misleading sales practices, Commission examination staff initiated a second examination sweep to review how other securities products are sold to military personnel. This review is on-going. It encompasses sales of all securities products, such as mutual funds, variable annuities, stocks and bonds, with a particular focus on sales offices targeting military personnel and their families.

These examinations are focused on sales practices in both the on and off-base communities, and on the unique features of the military market. In particular, examination staff are looking for sales practices that take advantage of military personnel when they receive deployment orders or of survivors when they receive large insurance payments upon a military person's death. In addition, the staff is considering whether broker-dealers are recommending unsuitable products to military investors, such as by recommending products that require a stream of payments that the investor is unlikely to have the resources to sustain. Finally, the staff are examining how firms characterize the availability of the Thrift Savings Plan to military investors.

Commission staff began the examination sweep by working with DoD and the NASD to identify the broker-dealer firms actually selling to military clients. Because there is no requirement for a broker-dealer to report the type of customers that the brokerage firm serves, the initial identification process included combing through various DoD-related newspapers and periodicals, such as *Stars & Stripes* and *The Military Times,* to identify and evaluate securities product advertisements. We also reviewed DoD base structure reports to determine which military facilities, domestic and overseas, have the largest numbers of enlisted personnel. These locations were cross-referenced with registration information on broker-dealers.

As a result of this review, and through interviews with knowledgeable personnel in the military and the securities community, we identified firms that direct their securities sales efforts to military personnel. We identified three types of firms that sell securities to military members:

- A small number of broker-dealer firms focus or specialize in selling securities to the military market. These are firms that have dedicated either their entire organization or a significant business line to serving the military market.
- There are also smaller broker-dealer firms that may have a single office or offices located near a military base in the United States or overseas, and which focus sales efforts on military personnel.
- Finally, there are also broker-dealer firms that do not focus on sales to the military, but may have a single sales branch office located in a military community and may develop a local military clientele. In addition to selling securities, these sales offices may provide a range of other financial services, including insurance, paycheck loans, and tax preparation.

In coordination with NASD, examinations of each type of firm have been or are being conducted. All firms that specialize in selling securities products to military personnel have been or are being examined, and, as well, examinations have been and are being conducted of the smaller firms and firms that have branch office locations near base communities. As part of this review, SEC examiners have conducted unannounced examinations of sales offices located outside the gates of major military bases. We continue to schedule these examinations.

Initial staff findings have not indicated serious sales practice abuses, but have noted deficiencies in the internal controls and supervisory systems of several firms. In some cases, it was unclear as to whether securities salespersons had ever received any type of supervisory oversight or compliance training. Our examinations are continuing and we will make referrals as appropriate.

COORDINATION WITH DOD

The staff is committed to working closely with DoD to ensure that our efforts in this area are fully coordinated. To this end, we have established a designated liaison

on the Commission's examination staff who has worked closely with the DoD. The liaison regularly communicates with designated DoD personnel, including frequent meetings and weekly conference calls. Through these contacts, we have shared information and coordinated our efforts. For example, DoD has conducted a survey of base commands, given us information regarding possible examination candidates and issues, as well as instructed base commands to provide local support and assistance to our examiners.

We have also coordinated our efforts with the commands of selected bases. With the assistance of base commanders, we have been able to conduct a systematic review of base records and interview base personnel to identify firms selling securities to the local military community, as well as possible complaints about those sales. Through this cooperation, we have been able to gain access to a number of useful records, including complaints, "off-limits" procedures, the issuance of "solicitation passes" to securities salesmen who wish to enter the premises of the base, the revocation of such passes, and other related matters. In addition, beyond providing us with access to records and information, base commands have taken active and affirmative steps to assist us.

In our work we have found DoD and the base commands to be open, responsive, and helpful. This coordination is continuing, with DoD providing us with on-going information that we are using to target base communities and securities firms for future examinations.

COORDINATION WITH THE NASD

We have coordinated our efforts with the NASD at all levels of this program. This joint effort has included coordination of enforcement activity, examinations, and investor education programs for the military. The enforcement action against *First Command Financial Planners, Inc.* was brought after coordinated investigations by Commission and NASD staff. The risk-targeted examination sweeps described above were coordinated with the NASD, as are the investor education programs for military members described below.

INVESTOR EDUCATION

The Commission is committed to improving the financial literacy of our servicemembers and their families. By actively promoting and supporting financial education for military personnel, we help military investors become better positioned to achieve personal saving and investing goals, including retirement, homeownership, and college education for their children.

Through the Commission's Office of Investor Education and Assistance, the Commission participates, as a charter member, in the DoD's *Financial Readiness Campaign.* The DoD launched the *Financial Readiness Campaign* to give servicemembers and their families a chance to learn more about personal finances and to encourage them to better manage their money. The effort is directed toward junior enlisted servicemembers and spouses of servicemembers because they are less likely to have received the personal finance information that servicemembers received as part of their training. We have pledged our support to the personnel at military installations who are responsible for providing financial education.

Over the past year, the Commission's staff have conducted several workshops at military installations for military personal financial managers, educators, command financial specialists, and servicemembers. We have also distributed brochures to these groups containing neutral, unbiased information on saving and investing. We continue to work with DoD to provide useful financial information.

The Commission's staff have also created additional educational materials to help investors understand and make informed decisions regarding periodic payment plans. We published an article on these plans earlier this year in *Military Money,* a free magazine focusing on the finances and lifestyle of military families. The magazine is distributed at most U.S. military bases nationwide, to military personnel in Europe and Asia via the *Stars and Stripes* newspaper, and to approximately 180 DoD commissaries worldwide. We plan to continue to publish articles in this magazine, as part of the *Financial Readiness Campaign,* which is supported by the Office of the Under Secretary of Defense for Military Community and Family Policy.

In addition, in August 2004, we posted on our website a comprehensive online brochure on mutual fund contractual plans titled *"Periodic Payment Plans."* Articles about these plans also appeared in newspapers distributed to military personnel, such as *Army Times* and *Marine Corps Times,* and have directed readers to our online brochure.

In addition, the Commission's staff have conducted an outreach program to the securities community. We believe that securities professionals can play a key role in protecting the financial interests of servicemembers. Members of the Commis-

sion's staff have spoken to industry conferences and seminars, identifying the military community as a risk group that should be given extra compliance attention.

**GAO's Recommendations**

We strongly agree with GAO's recommendation that Congress revisit the law governing mutual fund contractual plans. As an alternative to an outright ban, we believe that Congress could consider addressing excessive sales charges by, for example, reducing the maximum allowable load or working with the Commission and the NASD on other mechanisms that would provide protection against excessive sales loads in this product.

In addition, in the event periodic payment plans are not banned, securities regulators will consider various means of better assuring that regulators have adequate information to assess the sales of these plans. In particular, as GAO notes in its report, SEC and NASD efforts to review sales of periodic payment plans were hampered by a lack of standardized data at these firms on the persistency rates of the investments in the plans. Should these plans not be banned, we will work with other regulators to ensure that we have adequate information to assess the sales of those plans.

We fully support GAO's recommendation that the Commission and DoD share information and coordinate their efforts. As described above, the Commission and its staff have already taken steps to implement this recommendation, and have seen positive results from our efforts.

**Conclusion**

The Commission strongly believes that our servicemen and women must be protected from illegal and abusive practices in the sale of securities. Over the last year, the Commission and its staff have undertaken a comprehensive program to address such practices. Our program has included enforcement activity, extensive examination activity, close coordination with DoD and the NASD, and investor education and other outreach activity. We support the GAO's recommendations in this regard. We look forward to working closely with this Committee, DoD, the NASD, and other regulators to continue to protect members of the military as investors in our markets.

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## PREPARED STATEMENT OF MARY SCHAPIRO

VICE CHAIRMAN AND PRESIDENT, REGULATORY POLICY AND OVERSIGHT
NATIONAL ASSOCIATION OF SECURITIES DEALERS

NOVEMBER 17, 2005

Mr. Chairman and Members of the Subcommittee: NASD is grateful to the committee for inviting us to testify on NASD's regulatory activities regarding inappropriate sales of certain investment products to members of the armed forces, and for allowing us to submit this statement for the record.

**NASD**

Founded in 1936, NASD is the world's preeminent private-sector securities regulator. In 1939, the SEC approved NASD's registration as a national securities association under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—about 5,200 securities firms that operate more than 108,000 branch offices and employ about 664,000 registered representatives.

Our rules regulate every aspect of the brokerage business. Our market integrity and investor protection responsibilities include compliance examinations, rule writing, enforcement, professional training, licensing and registration, dispute resolution, and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules and the Federal securities laws, and we discipline those who fail to comply. Last year, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (830) from the securities industry than in any previous year. NASD has a nationwide staff of more than 2,400 and is overseen by a Board of Governors, more than half of whom are not in the securities industry. During the last 4 years, NASD has been in the process of separating from The Nasdaq Stock Market.

**Executive Summary**

America's men and women in uniform make great personal sacrifices to protect our Nation's security. They should not have to worry about the honesty and integrity of those who purport to help them make sound financial decisions for themselves and their families. Yet thousands of mostly young servicepersons have been disadvantaged by the sale of an investment product called Periodic Payment Plans or PPP's.

NASD learned in 2003 that a broker-dealer, located in Texas, was targeting U.S. servicemen and women with these investment products and was doing so using improper sales practices. We have responded forcefully to end these practices, punish those responsible for them, ensure that their victims are recompensed for their losses, and educate military personnel broadly about investing and saving.

In this statement, we will tell the Committee (a) what we discovered and what we did about it; (b) our subsequent efforts to educate servicepersons and civilians about PPP's and investing more generally, so that they might avoid being taken advantage of; and (c) about NASD's belief in the need for legislative remedies to deal with abusive sales practices and enhancing the system by which information on securities firms and brokers is provided to the investing public.

**Sales of Periodic Payment Plans to the Military**

First Command Financial Planning Inc., of Fort Worth, Texas, a broker-dealer with strong ties to the military, had been marketing Periodic Payment Plans to members of the U.S. military for many years. In August 2003, NASD learned of concerns about First Command's sales to military personnel of products that levied huge upfront commissions. The staff immediately began an investigation and found that First Command used misleading statements in its sales literature and scripts to attract military customers to its products. Using these and other improper tactics, the firm sold more than a half-million of these complicated and often extremely expensive products to service persons, many of whom were young and inexperienced investors.

An investor in a Periodic Payment Plan makes monthly payments of as little as $50 for a fixed time period, usually 15 years. The payments are invested in an underlying mutual fund and the investor is charged a 50 percent sales load on the first 12 monthly payments. Payments during the remainder of the 15-year term are not subject to sales loads, so that the effective sales charge decreases so long as the investor continues to make contributions. However, if the investor does not terminate the plan within 45 days, yet fails to make contributions over the full 15-year term, he or she can pay a sales charge of up to 50 percent of the total amount invested.

In their sales pitches, First Command representatives told potential customers that the 50 percent first-year sales load would decrease to 3.3 percent upon completion of the term. They said this high upfront sales load would serve as an incentive for investors to complete the plan. However, they failed to divulge that their own data showed that, historically, only 43 percent of First Command's customers completed the 15-year term. As a result, more than half of First Command's customers paid a higher—in many cases, significantly higher—sales load for their mutual fund purchases.

Company sales representatives also told potential customers that the 50 percent first-year sales load was intended to "instill discipline," but they did not inform the customer of the lost earnings potential from the cash that was not invested during the first 12 months.

Sales representatives also made misleading statements about alternative products. They said, for example, that no-load mutual funds had higher costs than other investment products and were primarily for "market speculators."

First Command training manuals cautioned its brokers not to suggest to individuals who preferred no load funds that they talk to people who had already bought PPP's, as this would be "like voluntarily spreading a cancer in your market." In addition to the problematic sales practices, our investigation found that a First Command district supervisor had inappropriately confronted an Air Force officer who had complained about First Command's sales tactics in an e-mail to numerous individuals. The officer wrote that he had lost money on his investment and advised readers not to do business with the firm. A First Command district supervisor informed the officer that high-level Air Force commanders were being told of his complaint and that a temporary duty assignment might be jeopardized. The supervisor also contacted the officer's squadron commander and told her First Command might file a grievance against her subordinate.

First Command eventually sent the officer a written apology, but took no action against their district supervisor.

**How NASD Responded**

After a thorough investigation of First Command's sales practices that included NASD taking testimony from 16 current and former First Command employees, reviewing more than 25,000 pages of documents and over 50,000 e-mail messages, NASD and the SEC both brought disciplinary actions against the firm simultaneously.

NASD censured the firm and fined it $12 million in December 2004. That amount included restitution to thousands of customers who had terminated PPP's after January 1, 1999 and had paid effective sales charges greater than 5 percent. As of October 18, 2005, more than $4.3 million had been returned to these customers.

The remaining funds, about $6.8 million, were transferred to the NASD Investor Education Foundation to be dedicated to financial education programs for members of the armed services and their families.

NASD also ordered First Command to hire an independent consultant to oversee its restitution payments and review its sales practices. In addition, NASD required that for 1 year First Command submit its proposed advertising materials to NASD for review prior to use.

NASD separately fined the First Command supervisor who had inappropriately confronted the complaining Air Force officer $25,000 and suspended him from acting in a supervisory role for 30 days.

First Command has informed NASD that it has ceased selling PPP's. We note that First Command was not the only firm selling PPP's to military servicepersons. NASD has ongoing investigations of additional, smaller, firms that also sold the plans, although most of them have now stopped. Statistics show that the rate of new PPP account openings at one of the largest sponsors has dropped from about 1,000 per month to about 10 per month.

Like any regulator, NASD is heavily dependent on customer complaints as an impetus for investigations and enforcement actions. It is important to note that in the case of First Command, NASD received no complaints from servicepersons. We subsequently learned that servicepersons had complained to military attorneys but those lawyers could not relay this information to NASD without specific consent from their clients. We began our investigation in August 2003, immediately after an article about First Command appeared in *Kiplinger's Personal Finance* magazine.

We therefore support the GAO recommendation to the Secretary of Defense that he revise the DoD solicitation policy to require that information on servicemember's complaints related to financial product sales be provided to relevant State and Federal financial regulators. We also support the recommendation that information be provided to servicemembers of all levels about how and to whom they should raise concerns or complaints about potentially inappropriate sales of financial products, including providing the information necessary for contacting the regulators. NASD has designated staff to receive complaints from military personnel and conduct outreach with DoD to proactively learn of issues concerning securities sales to military personnel.

**NASD Financial Education Efforts for the Military**

Since the settlement with First Command, NASD has devoted a great deal of time, money and attention to developing a program for providing financial education to military servicepersons and their families.

The First Command case illustrates most vividly the need for the education and protection of military servicepersons and family members who invest in securities.

NASD established the Foundation in December 2003, inspired in part by survey data that showed mainstream investors had a troubling lack of knowledge and understanding of markets and investment products. Since then, we have contributed $31 million to the foundation, and it has awarded more than $5 million in grants to universities and nonprofit organizations that provide research and teaching in the service of investors.

As mentioned above, approximately $6.8 million of the First Command settlement funds has been transferred to the NASD Investor Education Foundation and specifically earmarked for programs designed to help members of the military and their families better understand basic investing and the markets.

This money will fund the foundation's new Military Financial Education Program. We have been working closely with the Department of Defense and we expect to launch a multifaceted military financial education program in early 2006. The program will be implemented on military installations nationwide and will strive to encourage members of the armed forces to take control of their financial futures—by providing them and their and spouses with financial information to help them make intelligent saving and investing decisions.

Through a combination of its own initiatives and partner programs funded by foundation grants, the foundation will bring the financial education community together with the goals of empowering individuals to learn more in less time, helping organizations work together on new and existing initiatives, and establishing more coordinated and uniform financial education programs. Specific programs will include:

- A military-specific online resource center that will serve as a centralized, trustworthy source of unbiased information on saving and investing, including learning centers, interactive tools and games, links to other resources, frequently asked questions and more.
- On-the-ground training efforts to support the military's current Personal Financial Management program by establishing a coordinated and uniform financial education program, including the training and continued certification of personal financial managers and other volunteers.
- Educational toolkits for trainers and investors offering multiple levels of personal financial information.

To ensure that these programs and tools are well-exploited by the military community, the foundation efforts will include a long-term, public awareness campaign that will:

- Provide a coordinated, national financial literacy campaign to a military population that is often unable to set and achieve financial goals, unwilling or unable to save, overextended in debt, vulnerable to fraud and unaware of what can be done to gain control of the situation.
- Help military families understand how the financial choices they make can either improve or diminish their ability to achieve goals such as homeownership, a college education, a secure retirement, and peace of mind.
- Communicate positive and motivational messages in a variety of ways and through a diversity of media so that everyone in the military has the opportunity to see, understand, and act upon them.

In order to ensure the Military Financial Education Program's effectiveness, the NASD Investor Education Foundation plans to conduct both qualitative and quantitative research that will determine current levels of investment knowledge among military personnel, identify motivations for seeking educational opportunities, discover how they typically access saving and investing information, and identify trustworthy sources of information.

**S. 418 The Military Personnel Financial Services Protection Act**

NASD supports legislation that not only would ban sales of PPP's, but would also enhance and improve the method by which basic information about brokers and firms is provided to the investing public.

S. 1A418, introduced by Senator Enzi, and cosponsored by several other Senators, including Senators Hagel and Schumer of this Committee, would halt completely the sale of PPP's to members of the investing public, including the military. We agree with Senator Enzi that the excessive sales charges of these contractually based financial products make them susceptible to abusive and misleading sales practices and that a small group of individuals have targeted these products almost entirely to military.

NASD also agrees with Senator Enzi that there is a great value to investors having real-time access to information regarding the background, qualifications, and disciplinary history of securities professionals with whom they consider doing business. As we saw in the First Command situation, unsophisticated investors can be subjected to high-pressure sales tactics. In these situations, immediate access to information such as the disciplinary history of the salesperson can be crucial. All too often, learning about your broker after purchasing can be too late.

A provision in Senator Enzi's bill would revise the requirements for collecting and retaining registration information about securities firms and their brokers and for providing such information to investors.

Under Federal and State law, securities firms and brokers must provide information to regulators through a system operated by NASD, called "BrokerCheck." This information, including both administrative information and disciplinary history, is reported to NASD by securities firms, brokers, and other regulators, including the States.

In 1990, Congress mandated that NASD make relevant portions of the information available to the public without charge through a toll-free telephone number, the easiest and most convenient solution at the time. In so doing, Congress accorded NASD immunity from liability for the release of such information to the public—recognizing that the disclosure of key information about securities firms and brokers

is a critical part of NASD's regulatory and investor protection mission and that the veracity of the information reported to NASD cannot be independently verified. Therefore the grant of immunity from liability for release of this information was needed.

Because of the narrow language of the existing statute, NASD is not able to make "disclosure information" available online. Investors must request and wait for a written disclosure report to be mailed or e-mailed to them.

Informed investors are critical to market integrity and investor protection. Ready access through NASD BrokerCheck to complete information about their brokers and the firms that employ them is critical to informing investors and building their confidence.

Investors have embraced the Internet as their preferred means of obtaining information about securities firms and brokers. Of the more than 3.75 million inquiries the NASD BrokerCheck program has received thus far this year, over 98 percent came through the Internet and less than 2 percent by telephone.

Investors want and need online access to disclosure information to help them decide whether to do business with a securities firm or broker. The proposed legislation will permit NASD to put disclosure information online with appropriate protections against indiscriminate access and exclusion of information that could be used for "identity theft."

The legislation NASD favors would:

- Provide an appropriate limitation of liability for acts taken or omissions made in good faith.
- Require NASD to continue its BrokerCheck program, without charge to individual investors.
- Provide NASD flexibility in providing investor access to the program through the Internet and future technology.
- Maintain the requirement for toll-free telephone access for those investors who do not use, or prefer not to use, the Internet.
- Expressly provide for SEC review and approval of the scope, presentation, and procedures of the NASD BrokerCheck program.
- Require NASD, subject to SEC approval, to implement appropriate procedures for brokers or others to dispute the accuracy of information disclosure through the BrokerCheck program.

**Conclusion**

Thank you for giving us the opportunity to testify on these important topics and for your important work on this issue. America's men and women in uniform deserve honesty and integrity from those who sell them financial products. NASD will continue its work to protect all investors, including those in our Nation's military.

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## PREPARED STATEMENT OF JOHN OXENDINE

COMMISSIONER OF INSURANCE, STATE OF GEORGIA

NOVEMBER 17, 2005

**Introduction**

My name is John Oxendine. I am Commissioner of Insurance for the State of Georgia, a State that has been active in investigating and preventing sales abuses involving military personnel. Today, I am testifying on behalf of the National Association of Insurance Commissioners (NAIC). We appreciate the opportunity to testify regarding the role of the State insurance departments and NAIC in better protecting military insurance consumers from faulty life insurance products and abusive sales practices.

Today, I want to make three basic points:

- First, America's men and women serving in the armed forces are also American consumers entitled to the same protections under State law enjoyed by all other citizens. Protecting insurance consumers at the local level in the communities where they live has been the hallmark of State regulation for more than a century. Every State in this Nation has a strong unfair trade practices law backed by an insurance department staffed with dedicated employees trained to assist consumers who purchase insurance products and file claims.
- Second, State regulators recognize that insurance consumers serving our country in the military deserve special attention from State and Federal officials responsible for supervising the sales of life insurance and investment products on military bases in the United States and overseas. We are actively reaching out to

military authorities to educate them about State consumer protection resources and coordinate our enforcement activities. The military's chain of command structure emphasizing obedience to superiors poses unique consumer protection challenges that differ from civilian society. The same training, working, and living environment that produces highly disciplined and loyal military units to defend America's freedoms can also create pressures on individuals that may negatively affect their ability to make fully independent and informed decisions regarding the most sensible financial products for their own personal security.

- Third, State insurance regulators and the NAIC support Federal legislation that would clarify our authority under the McCarran-Ferguson Act and the Gramm-Leach-Bliley Act (GLBA) to supervise the business of insurance wherever it occurs, including military bases. We agree with the Government Accountability Office (GAO) that the Federal Government should facilitate cooperation among the Department of Defense (DoD), military base commanders, and State insurance departments by opening up lines of communication and sharing relevant information about consumer complaints and known violations. We believe that H.R. 458, the Military Personnel Financial Services Protection Act, would help achieve those goals. However, the version passed by the House of Representatives needs to be amended to remove unnecessary directives that could undermine State supervision authority under GLBA and deflect State efforts to address the real problems identified by State insurance regulators and GAO.

**State Insurance Regulators Have Expertise and Resources to Help the Military**

Paying for insurance products is one of the largest annual household expenditures of any kind for most Americans. Consumers—including military personnel—have an enormous financial and emotional stake in making sure the promises made by insurance companies are kept. Because people often have trouble understanding insurance products and sales practices, State governments devote substantial resources toward educating and assisting the public on insurance matters, as well as licensing and monitoring insurance companies and agents. When problems arise, State insurance departments are fully staffed to handle consumer inquiries and complaints quickly with a local phone call.

People who live and work on military bases are an integral part of the communities where they are located. Like other citizens, they can rely upon the expertise and help of State regulatory staff who are also local residents to understand and benefit from the laws that govern insurance products. As regulators, we are responsible for making sure their legitimate expectations are met regarding financial safety and fair treatment by insurance providers. During 2003, State insurance departments handled approximately 3.4 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents.

**NAIC and State Regulators Are Actively Assisting Military Personnel and DoD**

As recognized by GAO in its report, "Financial Product Sales; Actions Needed to Better Protect Military Members", State regulators must be aware of insurance problems before they can help remedy them. Prior to media reports last year, military insurance sales problems were not being brought to our attention because there were few complaints to State regulators about the products involved and there was no NAIC coding of complaints to signify they came from military sources. Once we became aware of problems, enforcement investigations were launched in States where they occurred, and NAIC commenced an active program to educate regulators, military personnel, and DoD about State resources for protecting military insurance consumers.

We believe State insurance regulators and the NAIC are taking actions that will meet the major recommendations of GAO in its report. Here are the key initiatives being undertaken:

- The NAIC set up the Sale of Life Insurance to Military Service Members Collaborative Group, which has 30 States participating. There are currently targeted market conduct examinations underway involving nine insurers.
- The NAIC, in conjunction with the DoD, developed a consumer brochure specifically addressing life insurance information for military personnel. We have encouraged DoD to make this brochure freely available to members of the armed services during training and on-base at convenient locations.
- The NAIC created an extensive online resource specifically aimed at helping military personnel purchase life insurance as well as other insurance products. In addition to explanations and tips about buying insurance, the NAIC military in-

surance webpage includes information on how to electronically file a complaint with State insurance departments, as well as links and contact information for the insurance department in each State, links to consumer help sites maintained by the military services and Federal agencies, and links to pending legislation in Congress. The military assistance webpage is featured on NAIC's main page at *www.naic.org*.

- Since becoming aware of military sales problems, State insurance regulators have reached out to the DoD. Diane Koken, the Pennsylvania Insurance Commissioner and NAIC President, visited twice this year with DoD leaders to foster a relationship of ongoing cooperation. The NAIC's efforts include: (1) compiling a list of insurance department contacts for the DoD to ensure military officials have proper information for getting State assistance; (2) updating the NAIC's Complaint Database System form to identify complaints that are submitted by military personnel; and (3) providing the DoD with a State-by-State premium volume summary for those companies that state insurance regulators know are soliciting or have solicited insurance products on military bases.
- The NAIC believes basic financial literacy training of military personnel should include assistance information and contact data for State insurance departments. Many people are not aware these valuable resources exist to help them at no cost as part of State government, or that State regulators can help prevent or resolve insurance problems that occur on military installations not otherwise under State jurisdiction. We intend to keep working with DoD to develop training programs and materials that communicate with military insurance consumers in clear and direct language which is easily understood.
- During 2006, the NAIC's Life Insurance & Annuities (A) Committee will be reviewing the types of life insurance which has been sold to military personnel in order to recommend a position on the products being offered in the marketplace.
- Finally, State insurance departments already have strong prohibitions against misleading and deceptive sales practices, and will continue to enforce these prohibitions when inappropriate activity is identified.

The GAO report recommends that Congress direct State regulators to conduct legal compliance reviews of existing insurance products, and cooperate with DoD in developing "suitability" standards for insurance products sold to military personnel in the future. The NAIC does not believe Congress needs to "direct" State officials or NAIC to meet their public responsibilities, especially in view of the strong actions taken by them in response to problems identified in the media. While the NAIC will continue to provide full cooperation and technical assistance to Federal officials, we believe it is appropriately within the sole domain of DoD to determine what is best for military personnel since DoD understands and is responsible for the military command structure and financial benefits that apply to America's men and women in uniform.

**In Order to Better Help Soldiers, State Regulators Need More Help from DoD**

In its report, the GAO noted that DoD should provide State insurance regulators with complete access to data on complaints by military personnel, but is reluctant to do so. The NAIC agrees with GAO regarding the need for State insurance departments to obtain all complaint information and administrative actions from DoD as early as possible. Insurance regulators review complaint information and regulatory actions to identify potential patterns and practices of conduct that could indicate violations that might not be apparent to local base commanders. State regulators can take corrective actions sooner rather than later if timely and complete information is available for review. We encourage DoD to improve its ability to fully share information with us for the benefit of military insurance consumers.

To facilitate State cooperation and information sharing with military authorities on insurance matters, the NAIC plans to invite DoD representatives to attend the NAIC's Winter National Meeting, which will be held in Chicago, Illinois from December 3–6, 2005. Representatives of the Federal banking agencies already attend NAIC meetings, and have found it useful as a way of promoting our common regulatory goals under GLBA. We believe personal interaction between DoD and State insurance regulators would further enhance our ability to communicate and protect military personnel from inappropriate sales practices. The NAIC would also like to extend an offer to develop a Memorandum of Understanding between DoD and individual State insurance departments to address any outstanding confidentiality issues surrounding the sharing of information.

**Comments on H.R. 458**

H.R. 458, the "Military Personnel Services Protection Act", passed the House of Representatives by a vote of 402–2 on June 28, 2005, and is now pending before the Senate Committee on Banking, Housing, and Urban Affairs. The NAIC would like to offer these comments regarding the sections of H.R. 458 that affect State insurance regulation.

*Section 105*—This section clarifies the jurisdiction of State insurance regulators on Federal land and facilities, as well as which State's law should apply. The NAIC fully supports enactment of this section.

*Section 106*—This section expresses a Congressional intent that States should work cooperatively with DoD to ensure implementation of appropriate standards to protect armed forces personnel, and additionally that each State should identify its role in promoting uniform standards within 12 months. The section also says NAIC should conduct a study of State compliance and issue a report to Congress.

State regulators and the NAIC are already meeting the intentions expressed in Section 106 through the enforcement of long-standing State prohibitions against misleading and deceptive sales practices, and will continue to do so because we are just as much concerned as Congress about protecting military personnel. Moreover, the statutory intention that States spend their time and resources adopting uniform national standards at the direction of Congress diverts attention and effort from fixing the real problems that occur in States with major military bases, while also needlessly undercutting the equal authority of states as functional regulators of insurance that is mandated in GLBA. As a practical matter, State regulators and NAIC are effectively working together and cooperating with DoD at the present time. Consequently, the NAIC recommends that Section 106 be deleted from H.R. 458 because it is unnecessary and counterproductive to enhancing the authority of State insurance regulators set forth in GLBA and other parts of H.R. 458.

*Section 107*—This section provides that insurers and producers shall not sell life insurance products to members of the armed forces without proper disclosures. It also provides that States will be involved in enforcing these disclosure requirements. The NAIC fully supports the disclosure and enforcement provisions in Section 107.

*Section 108*—This section expresses a Congressional intent that NAIC should consult with DoD and submit a report to Congress within 12 months on ways of improving the quality and sales of insurance on military installations. If NAIC does not submit a report, the GAO is directed to do it. The NAIC has always cooperated fully with requests of Congress and GAO for information and assistance. There is no need for the statutory directive to NAIC in Section 108, since a simple request is sufficient to produce the desired results. The NAIC recommends deleting any statutory inference which infers that NAIC might not meet a Congressional request for information and assistance on military insurance issues.

*Section 109*—This section requires that insurers operating on military bases implement a system to check and report to State officials regarding disciplinary actions against producers representing the insurer, and that States set up a collective system to receive such reports. There is also an expression of Congressional intent that States achieve this goal within 2 years. The NAIC supports the goals of this section, but questions whether a Federal statutory directive to States is needed to achieve the desired results.

*Section 111*—This section expresses a Congressional intent that State agencies provide advice to Federal entities regarding insurance coverage issues. The NAIC is already meeting this goal, and will continue to do so.

**Conclusion**

All of us share a commitment to assuring that America's armed forces personnel receive fair treatment, solid advice, and strong consumer protections with respect to the insurance products they purchase. State insurance regulators and NAIC are meeting that commitment with effective outreach to the military, useful educational resources, and active enforcement of State laws to protect military insurance consumers. We look forward to continuing our efforts, and to working more closely with Congress and DoD to make the consumer protection system meet the high expectations which military personnel rightly deserve.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM MARY SCHAPIRO**

**Q.1.** Did the National Association of Securities Dealers encounter a lack of cooperation from the Air Force or the Department of Defense during the NASD investigation of First Command Financial Planning, Inc.?

**A.1.** NASD did not encounter a lack of cooperation from the Air Force or the Department of Defense during the investigation of First Command Financial Planning, Inc. However, we were informed by a JAG officer working in the Air Force headquarters for legal assistance that, because of Air Force regulations, he could not give us information about complaints that had been filed with Air Force legal offices without specific individual client consent. While he also informed us that he encouraged individuals with complaints to contact NASD, the staff did not receive any complaints.

**Q.2.** The GAO reported that "contractual plans have been periodically involved in sales scandals for decade." Why did misconduct in sales of this type of product persist "for decades?" As a result of the recent occurrences, what have the regulators learned?

**A.2.** As noted in the statement that NASD submitted, we agree that the excessive sales charges of these contractual-based financial products make them susceptible to abusive and misleading sales practices. NASD supports legislation that would ban sales of these products. NASD rules preclude brokerage firms from charging customers sales loads at this level for ordinary mutual funds, and absent specific legislative authorization of this product's sales charges, NASD members would not be permitted to sell any financial product with 50 percent first year sales charges. Section 27 of the Investment Company Act of 1940 permits contractual plans to impose huge front-end sales loads, which naturally leads to sales practice abuses. While this authority does not limit NASD's obligation to examine broker-dealers that sell contractual plans, eliminating the potential for huge front-end loads by amending Section 27 of the 1940 Act would also lead to fewer abuses related to the sales of these plans.

**Q.3.** The GAO report states that "although sales of securities products are covered by suitability standards, securities regulators also rely on receiving complaints to initiate actions and were, therefore, not generally aware of problems involving military members and contractual plans until press reports appeared." Do you agree with this conclusion? What means other than investor complaints enable the regulators to identify sales practice abuses?

**A.3.** NASD agrees that customer complaints are a significant source of information alerting regulators to potential problems in the sale of investment products. We are also alerted to sales practice abuses through NASD's periodic brokerage firm examinations, focused sweep examinations, filings required to be made by brokerage firms (for example, when the firm terminates a registered representative for cause), discussions with industry representatives through NASD Board standing committees, conferences, and other channels, press reports, and anonymous tips. In addition, NASD fo-

cuses resources on monitoring industry trends and seeking out problematic areas likely to occur.

**Q.4.** The NASD, in a press release dated December 15, 2004, announced the settlement of disciplinary proceedings against a major seller of periodic payment contracts to military personnel that was "[u]sing misleading sales scripts, inappropriate comparisons and omissions if important information." The NASD's long-standing rule on "Communication with the Public" requires broker-dealers to file certain advertisements and sales literature concerning registered investment companies" with NASD "within 10 business days of first use of publication."

Please describe the NASD's process of reviewing the advertisements and sales materials used by brokerage firms. In light of recent public concern about sales practices involving the systematic investment plans, has the NASD reviewed or modified the standards it uses to review advertising and sales materials?

**A.4.** Over the past 4 years, NASD has reviewed in excess of 350,000 [1] brokerage advertisements and other items of sales material. NASD conducts these reviews through several different programs involving staff in its Advertising Regulation Department as well as the District Offices and the Department of Enforcement.

### Filings

NASD reviews the largest volume of brokerage firm advertisements and other sales material through routine filings made with the Advertising Regulation Department (the Department). As noted in the inquiry, brokerage firms file certain communications with the Department pursuant to rule requirements. The majority of material filed concerns registered investment company securities including mutual funds, variable annuities, variable life insurance, and unit investment trusts. Historically, communications about systematic investment plans reflect a very tiny subset of the investment company communications reviewed. In the past year, since the disciplinary proceeding referenced in the inquiry, this volume has declined further.

When a brokerage firm files an advertisement or other communication with the Department, the analyst assigned to the specific firm conducts a review for compliance with NASD rules as well as applicable SEC, MSRB, and SIPC standards. These reviews reflect the staff's analysis of the given communication based on the information available to the staff member at the time of the review. For example, it is expressly assumed that members' submissions are complete and accurate.

In response to each filing, staff provides the brokerage firm with an advisory review in the form of a written letter. When the staff observes substantive rule violations, it will refer them for further investigation and potential disciplinary action.

### Investigations

Department staff also reviews materials submitted by third parties as a complaint or inquiry. For example, NASD District Office

[1] Year by year, NASD reviewed the following:
Year—Communications Reviewed: 2005—89,653; 2004—88,301; 2003—85,735; 2002—87,855.

or Enforcement Department staff will uncover advertisements in connection with their examinations of brokerage firms. Where they detect problematic or questionable material, they will refer those items to Department staff for review and appropriate action. Generally, the Department staff will work with the referring office in resolving any rule violations observed in connection with an ongoing examination. For example, Department staff will provide ongoing analysis and support to the Enforcement Department as it pursues a formal disciplinary action against a given brokerage firm.

The Department also receives referrals from brokerage firms that are in competition with the firm that has used a given communication. Regulators at the Federal or State level may also refer items to the Department as will the occasional investor. The Department reviews every advertisement or other item of sales literature for compliance with applicable NASD, SEC, MSRB, and SIPC rules. If there are rule violations indicated, staff will contact the brokerage firm with commentary on the relative compliance of the subject advertisement and will provide a recommended course of action, for example, advise the firm to stop using a given advertisement completely or advise the firm to correct an advertisement before it is used further. The Department will obtain a written response from the brokerage firm as to its course of action, the origins of the problem advertisement and its immediate impact on the public. Depending on the rule violations and their scope, the Department may determine no further action is required, issue an informal disciplinary action against the firm, or refer the matter to the Enforcement Department requesting that the staff pursue formal disciplinary action.

**Sweeps**

Department staff conduct sweep reviews of brokerage firms' advertising and other sales material. The staff will contact a group of member firms to request specific types of communications that are not normally filed and may reflect an area of current regulatory interest for NASD. For example, recent sweeps have focused on communications about equity-indexed annuities, research reports, and hedge funds.

The Department reviews any sales communications provided in response to the sweep request and provides written commentary to the brokerage firm on items that fail to comply with applicable rules. As with investigations, the Department staff will request information in response to its comment letter and, upon receipt of such information, make a determination as to whether to close the matter or pursue disciplinary action from the sweep.

**Standards NASD Uses to Review Systematic Investment Plan Communications**

NASD continuously seeks to update and improve the standards it applies to members' communications. For example, NASD has recently proposed amendments to the rules governing advertising to require firms to file prior to use all television, radio, and video advertisements that are 15 seconds or longer as well as advertise-

ments concerning new products.[2] Similarly, NASD has also proposed stricter standards for the internal review and approval of correspondence (for example, letters, e-mail, and instant messages) with existing retail customers.[3]

The standards implicated in the disciplinary proceeding noted above were some of the most fundamental applicable to brokerage firm communications, that is, the prohibition on misleading statements, the requirement that members' communications be fair, balanced, and complete, and the requirement that comparisons include all relevant material differences between the subjects of the comparison.[4] Accordingly, NASD appears to have sufficient standards in place to pursue rule violations in this area going forward. In addition, should Congress adopt the proposed ban on systematic investment plans advocated by NASD, there would be even less need to adopt specialized rules.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR SARBANES FROM JOHN OXENDINE**

**Q.1.** GAO notes that many States lack appropriateness or suitability standards for sales of insurance products to military members, so that investigators must prove that companies are misrepresenting products, which is difficult to do. Does the NAIC support GAO's recommendation that appropriateness or suitability standards for sales of insurance products to military personnel be developed? If not, why not?

**A.1.** In 2000, the NAIC adopted the white paper, "Suitability of Sales of Life Insurance & Annuities," which recommends that rules be developed requiring that suitability be determined by the producer and carrier in the sale of nonregistered life insurance and annuity products. While the NAIC agreed in concept that the development of suitability standards is necessary, the implementation of suitability standards is more difficult. Because of this, the NAIC first focused on the development of standards for seniors, which is the segment of the marketplace in which significant problems were identified. The NAIC membership adopted the Senior Protection in Annuity Transactions Model Regulation model in 2003. Today, approximately one-third of the States have some form of suitability standards that apply to seniors or the broader marketplace.

In testimony to Congress in November of 2005 the NAIC recognized the Department of Defense (DoD) is in the best position to know the needs of military personnel and pledged its full coopera-

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[2] See *Notice to Members 05–25,* copy attached.

[3] See *Notice to Members 05–27,* copy attached.

[4] NASD Rule 2210(d)(1) states, in part:

(A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

(B) No member may make any false, exaggerated, unwarranted, or misleading statement or claim in any communication with the public. No member may publish, circulate, or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

Further, NASD Rule 2210(d)(2)(B) states "Any comparison in advertisements or sales literature between investments or services must disclose all material differences between them, including (as applicable) investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features."

tion and technical support to the DoD in meeting the needs of military personnel. In addition, the NAIC's Life Insurance & Annuities (A) Committee has the following charge for 2006: Review life insurance sold with a side fund to recommend a position on the products being offered in the marketplace. Life insurance with a side fund is the predominate life insurance product being sold to the military today.

In early February 2006, the NAIC will hold its annual commissioners conference to discuss critical issues facing State insurance regulators in 2006 and to set the NAIC's strategic plan for 2006. The NAIC will discuss the development of suitability standards for life insurance products sold to military personnel during this conference and will provide additional comment on future NAIC activity after this conference.