



**Testimony**

**Of**

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**Before the  
Senate Committee on Banking,  
Housing and Urban Affairs**

**United States Senate**

**Hearing on Military Sales**

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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 pre-eminent 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 four 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 PPPs.

NASD learned in 2003 that a broker-dealer, located in Texas, was targeting U.S. service men 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 PPPs 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 PPPs, 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 PPPs after January 1, 1999 and had paid effective sales charges greater than five 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 one 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 PPPs. We note that First Command was not the only firm selling PPPs 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 service member'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 service members 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 non-profit 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 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 PPPs, but would enhance and improve the method by which basic information about brokers and firms is provided to the investing public.

S. 418, introduced by Senator Enzi, and co-sponsored by several other Senators, including Senators Hagel and Schumer of this Committee, would halt completely the sale of PPPs 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 sales person 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 two 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.