



**TESTIMONY  
OF  
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EXAMINATIONS**

**U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING  
SEC OVERSIGHT OF  
SALES OF SECURITIES TO MILITARY PERSONNEL**

**BEFORE THE  
COMMITTEE ON BANKING, HOUSING,  
AND URBAN AFFAIRS**

**UNITED STATES SENATE**

**NOVEMBER 17, 2005**

**100 F Street, NE  
Washington, D.C. 20549**

## **Testimony Concerning SEC Oversight of Sales of Securities to Military Personnel**

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

**November 17, 2005**

### **I. 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 towards 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.

## **II. 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 anti-fraud 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.<sup>1</sup>

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

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<sup>1</sup> A summary of these duties can be found on the Commission’s website. See [www.sec.gov/divisions/marketreg/bdguide.htm](http://www.sec.gov/divisions/marketreg/bdguide.htm).

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% 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 U.S. 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 twelve 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%), and the maximum portion of the first twelve monthly installment payments that may be deducted as sales load (50%), 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.<sup>2</sup> 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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<sup>2</sup> 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 eight 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 one percent (<0.2%) of the assets currently invested in non-money 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).<sup>3</sup> Nonetheless many members of the military have continued to invest in these plans.

### **III. 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.

#### **A. 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,

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<sup>3</sup> 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.

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% 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% 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% 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%. 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% 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%, the approximate average sales load for all conventional-load equity mutual funds in 2003. In the worst case, those who discontinued payments after one year paid a 50% 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, 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%. 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 anti-fraud 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% 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.

#### **B. 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.

##### **1. 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% 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% 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 ten years. Although the examinations of these firms did not reveal the sort of 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% completed their plans. On average, low-ranking enlisted members paid loads greater than 10% -- 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.

## **2. 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 U.S. 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.

### **C. 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.

#### **D. 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.

#### **E. Investor Education**

The Commission is committed to improving the financial literacy of our service members 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, home ownership, 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 service members and their families a chance to learn more about personal finances and to encourage them to better manage their money. The effort is directed towards junior enlisted service members and spouses of service members because they are less likely to have received the personal finance information that service members 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 service members. 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 service members. Members of the Commission's staff have spoken to industry conferences and seminars, identifying the military community as a risk group that should be given extra compliance attention.

#### **IV. 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.

## **V. 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.