

GAO

Report to the Committee on Banking,  
Housing, and Urban Affairs, U.S. Senate

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November 2005

# FINANCIAL PRODUCT SALES

## Actions Needed to Better Protect Military Members



G A O

Accountability \* Integrity \* Reliability

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Highlights of [GAO-06-23](#), a report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

## Why GAO Did This Study

In 2004, a series of press articles alleged that financial firms were marketing expensive and potentially unnecessary insurance or other financial products to members of the military. To assess whether military service members were adequately protected from inappropriate product sales, GAO examined (1) features and marketing of certain insurance products being sold to military members, (2) features and marketing of certain securities products being sold to military members, and (3) how financial regulators and the Department of Defense (DOD) were overseeing the sales of insurance and securities products to military members.

## What GAO Recommends

Matters that Congress should consider include banning contractual plans, requesting that insurance regulators conduct reviews to ensure that products being sold to military members meet existing insurance requirements, and ensuring development of appropriateness or suitability standards for such sales. GAO also recommends that DOD and financial regulators work cooperatively to help improve the oversight of such products. DOD and the financial regulators provided comments generally agreeing with this report and its recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-06-23](http://www.gao.gov/cgi-bin/getrpt?GAO-06-23).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

# FINANCIAL PRODUCT SALES

## Actions Needed to Better Protect Military Members

### What GAO Found

Thousands of junior enlisted service members have 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 service members that make steady payments and have provided millions in death benefits to the survivors of 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, the products also allow any savings accumulated on these products to be used to extend the insurance coverage if a service member 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 selling 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.

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 service member 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, regulators also question the need for contractual plans to continue to be sold.

Financial regulators were generally unaware of the problematic sales to military members because DOD personnel rarely forwarded service member complaints to them. Insurance products also usually lacked suitability or appropriateness standards that could have prompted regulators to investigate sales to military members sooner. Securities regulators' examinations of contractual plan sales were also hampered by lack of standardized data showing whether customers were benefiting from their purchases. Although recognizing a greater need for sharing information on violations of its solicitation policies and service member complaints, DOD has not revised 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.

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**Abbreviations**

DFAS	Defense Financial and Accounting Service
DOD	Department of Defense
DOJ	Department of Justice
IMSA	Insurance Marketplace Standards Association
NAIC	National Association of Insurance Commissioners
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
PCS	Permanent Change of Station
SEC	Securities Exchange Commission
TSP	Thrift Savings Plan
SGLI	Servicemembers' Group Life Insurance
VGLI	Veterans' Group Life Insurance

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United States Government Accountability Office  
Washington, D.C. 20548

November 2, 2005

The Honorable Richard Shelby  
Chairman  
The Honorable Paul S. Sarbanes  
Ranking Minority Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

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 marketing them during personal finance briefings on military bases in violation of Department of Defense (DOD) regulations. In addition, these accounts raised concerns about a firm that employed retired and former military members to market a mutual fund product with high up-front sales charges that was rarely being offered to civilians. As a result of these media accounts, Congress and others have become concerned over whether the men and women in the armed services are as adequately protected from inappropriate financial product sales as their civilian counterparts.

As a result of these allegations, you asked us to review the sales of financial products to members of the U.S. military. This report identifies (1) the extent to which certain insurance products were being sold to military members and how these products were being marketed, (2) the extent to which certain securities products were being sold to military members and how these products were being marketed, and (3) how financial regulators and DOD oversaw the sales of insurance and securities products to military members.

To identify the extent to which certain insurance products were sold and how they were marketed to military members, we contacted state insurance regulators in several states with active investigations of insurance sales involving service members. During this work, we interviewed regulatory staff and reviewed available information and materials as part of these regulatory investigative activities. We also reviewed documents and met with Department of Justice (DOJ) staff involved in investigating sales by insurance companies to military members. Additionally, we interviewed officials from six insurance companies that market to service members and reviewed their marketing

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materials. We also interviewed military personnel at two large training bases and reviewed documents pertaining to sales and complaints at these locations.<sup>1</sup> Furthermore, we obtained data on insurance sales to military members from DOD's Defense Finance and Accounting Service (DFAS), which maintains military personnel pay records. To identify the extent to which certain securities products were being sold and how these were being marketed to military members, we interviewed staff from federal, state, and other securities regulators; the largest broker-dealer firm that markets to military members; and two of the investment management firms that manage the mutual funds underlying some of the contractual plans sold to military members. To assess how financial regulators and DOD were overseeing financial product sales to military members, we interviewed state insurance and federal, state, and other securities regulators. We also reviewed materials pertaining to investigations and regulatory actions involving firms marketing to military members. Additionally, we contacted DOD officials, conducted fieldwork at two large military training installations, and reviewed findings from other recent work concerning supplemental life insurance sales conducted at several other military installations throughout the country. We conducted this work between November 2004 and October 2005 in accordance with generally accepted government auditing standards. (Additional information on our methodology is included in appendix I.)

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## Background

Members of the U.S. military serve in different branches in locations across the country and around the world. The various branches within DOD include the Department of the Air Force, the Department of the Army, and Department of the Navy, which also incorporates forces of the Marine Corps. DOD also oversees the members of the Coast Guard along with the Department of Transportation. As of 2004, approximately 1.4 million active duty military personnel served in the various branches in more than 6,000 locations. In addition, 2 million retirees receive pay and benefits from the department. DOD is also the largest employer and trainer of young adults in the United States, recruiting about 200,000 individuals into active duty in 2004—the majority of them recent high school graduates. As shown in

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<sup>1</sup>We also obtained information, including complaints and other alleged problems, involving insurance product sales at six additional military installations as part of a separate review. See GAO, *Military Personnel: DOD Needs Better Controls Over Supplemental Life Insurance Solicitation Policies Involving Servicemembers*, [GAO-05-696](#) (Washington, D.C.: June 29, 2005).

figure 1, the pay of typical junior enlisted staff—grades E-1 through E-3—ranges between \$1,143 and \$1,641 per month.

**Figure 1: Number of Service Members by Military Pay Grade Groupings (as of Year-end 2004)**

	Pay grade	Typical ranks	Monthly basic pay range	Number of military members	
				Subtotal	Total
<b>Enlisted service-members</b>	E-1 — E-3	Privates, Airmen, Seamen	 \$1,143 - \$1,641	328,553	<b>1,147,503</b>
	E-4 — E-6	Corporals, Petty Officers, Sergeants	 \$1,613 - \$2,908	683,240	
	E-7 — E-9	Sergeants First Class, Chief Petty Officers, Master Sergeants, First Sergeants, Sergeant Majors	 \$2,220 - \$5,232	135,710	
<b>Warrant officers</b>	W-1	Warrant Officers	 \$2,290 - \$3,660	13,085	<b>15,746</b>
	W-2 — W-5	Chief Warrant Officers	 \$2,594 - \$6,121	2,661	
<b>Commissioned officers</b>	O-1 — O-3	Lieutenants, Ensigns, Lieutenants Junior Grade, Captains	 \$2,344 - \$5,083	125,078	<b>210,224</b>
	O-4 — O-6	Majors, Lieutenant Commanders, Lieutenant Colonels, Commanders, Colonels, Captains	 \$3,554 - \$8,576	84,260	
	O-7 — O-10	Generals and Admirals	 \$6,666 - \$13,769	886	
				<b>1,373,473</b>	

Source: GAO analysis of DOD data.

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Entry-level military personnel are generally young and have limited education and incomes. A 2002 private research organization report that examined the financial situation of military members noted that the military hires primarily young, untrained, entry-level employees.<sup>2</sup> Comparing data from various surveys done of large numbers of civilians and military members, this report found that less than 5 percent of junior enlisted personnel held bachelor's degrees compared to 27 percent of the civilians.<sup>3</sup> In terms of income, this report found that 87 percent of junior enlisted personnel had total monthly family incomes of \$3,000 or less. However, a DOD commission that reviews military compensation has found that military members are paid at the 70th percentile or higher of comparably educated civilians. In addition, military members receive housing and subsistence benefits, with about half living in on-base housing and many having access to military facilities that provide meals.

Various aspects of the military life can increase the challenges that service members face in managing their finances. According to the private research report, factors that appeared to increase the financial distress among military members were the family separations resulting from changes in duty stations and deployments away from home. According to our report on military relocations, DOD reported that about one-third of all military members make Permanent Change of Station (PCS) moves every year.<sup>4</sup> The average length of time spent at each location can also be brief, with 20 percent of such relocations lasting less than 1 year and about 50 percent lasting 2 years or less. Leaving or retiring from the service also represents the last major transition in a service member's career, with data

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<sup>2</sup>Richard Buddin and D. Phuong Do, *Assessing the Personal Financial Problems of Junior Enlisted Personnel*, RAND Corporation, 2002.

<sup>3</sup>The report's data on civilians were drawn from the 1996 Panel Study of Income Dynamics, which was a nationally representative sample of 1,465 individuals. The survey is longitudinal and has been conducted annually since 1968. To be comparable to the military junior enlisted population, the authors excluded civilians who were full-time students or over the age of 40. The report's data on military members came from two surveys of military personnel. The first survey was a random sample of 6,200 enlisted members with 10 or less years of service conduct in 1997. This survey explored various dimensions of the reenlistment decision for junior enlisted personnel. The second survey was a 1999 random sample of enlisted and officer personnel in all service branches. This survey included about 36,000 respondents but this report analyzed the 8,000 respondents who were enlisted personnel with 10 or less years of military service.

<sup>4</sup>GAO, *Military Personnel: Longer Time between Moves Related to Higher Satisfaction and Retention*, [GAO-01-841](#) (Washington, D.C.: Aug. 3, 2001).



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indicating that most enlisted personnel leave after their initial duty commitment.<sup>5</sup>

As with their civilian counterparts, military service members may be offered various types of financial products, including life insurance. Types of life insurance commonly sold include term, whole, universal, and variable life insurance products. Many companies offer term life insurance, which generally provides basic death benefits for a specified time period, such as 10 or 20 years. At the end of this term, the insured can usually renew the coverage at a higher premium rate for another set term period. The coverage on a term policy may also end if the insured person ceases making the required periodic premium payments. Under a whole life policy, an insured person can make level premium payments, which will provide the specified amount of death benefits. Because the premium generally stays the same throughout the time that the policy is in force, premiums for whole life insurance are generally higher initially than for comparable amounts of term life coverage. Whole life insurance policies can build cash value, which can be borrowed upon, though this will reduce death benefits until the loan is repaid in full. Some whole life policies are known as “modified whole life insurance” in which the policyowner pays a lower than normal premium for a specified initial period, such as 5 years, after which time the premium increases to a higher amount that is payable for the life of the policy. Universal life products may also provide permanent insurance—like a whole life policy—but may also offer their purchasers more flexibility. Under such policies, the holder can vary the amount of the premium to build up the cash value of the policy by increasing the amount of the payment, or can pay less into the policy at other times, when money is needed for other purposes. Similarly, under a variable life policy, a cash value accumulates that can be used to invest in various instruments, such as common stocks, bonds, or mutual fund investments. However, with a variable life policy, the policyholder (and not the company) assumes the investment risk tied to the product. If these investments perform well, the death benefits paid on the policy can increase; conversely, if the investments perform poorly, the purchaser may have to increase their premiums to keep the policy in force.

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<sup>5</sup>D.R. Segal and M.W. Segal, “America’s Military Population,” *Population Bulletin*, vol. 59, no. 4 (Dec. 2004).

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The federal government offers service members life insurance as part of their total benefits package. Each member is eligible for inexpensive coverage under Servicemembers' Group Life Insurance (SGLI), which provides group term life insurance. Until September 1, 2005, service members were automatically covered for the maximum amount of \$250,000 of insurance on their first day of active duty status, unless they decline or reduce their coverage, but Congress has now increased this amount to \$400,000.<sup>6</sup> Service members leaving the military can also opt to continue coverage through the government-sponsored coverage provided to veterans. Although many life insurance policies exclude coverage for deaths resulting from acts of war, these government-sponsored policies do not contain this exclusion.

State government entities are the primary regulators of insurance companies and agents in the United States.<sup>7</sup> When first establishing operations, an insurance company must obtain a charter or license in order to write business in a state. This state becomes its state of domicile. Insurers may obtain approval to market products in multiple states, and therefore the sales by insurers can be overseen by multiple state regulators, though financial solvency of each company is primarily overseen by the regulator in the company's state of domicile. Some insurance companies market their products using their own proprietary sales force. Some companies may also use agents employed by independent firms who may be marketing the products of multiple companies to their customers. The state insurance regulators oversee the insurance companies and agents that do business in their jurisdictions in several ways, including reviewing and approving products for sale and examining the operations of companies to ensure their financial soundness or proper market conduct behavior.

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<sup>6</sup>The increase in coverage and various death payments was included in the Emergency Supplemental Appropriations Act for 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). This bill also increased the death gratuity paid upon a service member's death from \$12,000 to \$100,000 under certain circumstances. Some of the increases were made retroactively to October 1, 2001.

<sup>7</sup>Although insurance is generally exclusively regulated by state entities, some products offered by insurance companies are overseen by other regulators. For example, variable life insurance may be considered an investment vehicle due to the ability of the policy owner to direct the cash values or accumulation funds into various investment instruments. Unlike the other life insurance products, the variable life insurance product may have a dual regulatory enforcement; the life insurance portion regulated by the insurance regulator and the investment portion (cash value) regulated by securities regulators.

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Although each state has its own insurance regulator and laws, the National Association of Insurance Commissioners (NAIC) provides a national forum for addressing and resolving major insurance issues and for allowing regulators to develop consistent policies on the regulation of insurance when consistency is deemed appropriate. This association consists of the heads of each state insurance department, the District of Columbia, and four U.S. territories. It serves as a clearinghouse for exchanging information and provides a structure for interstate cooperation for examinations of multistate insurers. NAIC staff also coordinate the development of model insurance laws and regulations for consideration by states. Its staff also review state insurance departments' regulatory activities as part of its national financial accreditation program.

To meet their financial investment needs, military members may also be offered various securities products. These can include stocks issued by public companies that are traded in various markets, or debt securities, such as bonds that provide interest income to their holders. A common securities product that many investors purchase is a mutual fund. Mutual funds are investment companies that pool the money of many investors, and then invest them in other assets, such as stocks or bonds. By holding the shares of the mutual fund, investors can benefit from owning a broad portfolio of diversified securities managed by professional money managers, whose services they might otherwise be unable to obtain or afford. Investors are charged mutual fund fees, which cover the day-to-day costs of running a fund. Mutual funds are sold through a variety of distribution channels. For instance, investors can buy them directly by telephone or mail, or they can be sold by sales forces, such as the account representatives of third party broker-dealers. Some mutual funds assess sales charges (also called "loads"), which are generally paid at the time of purchase to compensate these sales personnel.<sup>8</sup>

Securities—and the firms that market them—are overseen by various regulators. At the federal level, the Securities and Exchange Commission (SEC) oversees securities issued by public companies. The firms that market securities to investors, known as broker-dealers, must also register and subject themselves to SEC oversight. This includes complying with

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<sup>8</sup>Loads that mutual funds impose at the time of purchase (other than through reinvestment of dividends or capital gains) are called "frontend loads." Some funds also offer classes of shares that impose contingent "deferred sales loads", which an investor may pay at the time the shares are sold. Such deferred sales loads decline and eventually disappear depending on how long an investor holds the shares.

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various requirements for regulatory reporting, financial soundness, and sales practice regulations designed to protect investors. In addition to oversight by SEC, broker-dealers also are overseen by private entities known as self-regulatory organizations. The New York Stock Exchange and NASD (formerly called the National Association of Securities Dealers) are two examples of such organizations. State regulators also oversee securities activities.

Congressional concerns over the adequacy of military member's financial literacy and the processes in place to address financial product sales have prompted recent reviews and legislative actions. In response to a Congressional committee's request to review military members' financial condition, we recently reviewed and reported on the financial condition of active duty service members and their families. We also reported on DOD's efforts to evaluate programs to assist deployed and non-deployed service members in managing their personal finances and the extent to which junior enlisted members received required personal financial management training.<sup>9</sup> As part of this study, we found that the financial conditions of deployed and non-deployed service members and their families are similar, but deployed service members and their families may face additional financial problems related to pay. We also found that DOD lacks an oversight framework for evaluating the effectiveness of its personal financial management training programs across services, and that some junior enlisted service members were not receiving personal financial management training required by service regulations. In addition, we reviewed and reported on the extent of violations of DOD's policies governing the solicitation of supplemental life insurance to active duty service members and DOD personnel's compliance with procedures for establishing payroll deductions (commonly referred to as allotments) for supplemental life insurance purchases.<sup>10</sup> The findings of this review are discussed later in this report.

In response to concerns over the sale of questionable financial products to military members, the House of Representatives passed legislation in 2004 and 2005 requiring additional protections for service members.<sup>11</sup> In

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<sup>9</sup>GAO, *Military Personnel: More DOD Actions Needed to Address Servicemembers' Personal Financial Management Issues*, [GAO-05-348](#) (Washington, D.C.: Apr. 26, 2005).

<sup>10</sup>[GAO-05-696](#).

<sup>11</sup>Military Personnel Financial Services Protection Act, H.R. 458, 109th Congress (2005).

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February 2005, a similar bill was introduced in the U.S. Senate.<sup>12</sup> Both bills contain various congressional findings, including the finding that military members are being offered high-cost securities and life insurance products by some financial services companies engaging in abusive and misleading sales practices. According to the bills, Congress finds that the regulation of these products and their sale on military bases has been clearly inadequate and requires congressional legislation to address these issues. These bills have been referred to the Senate Committee on Banking, Housing, and Urban Affairs for further consideration.

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## Results in Brief

State regulators in various states have found that a small number of insurance companies have been marketing a type of high-cost insurance product to thousands of low-ranking service members at military installations across the United States and around the world. According to state insurance regulators, at least six companies were targeting military members and selling a product that combines life insurance with a savings or investment fund that promises high returns but includes provisions that reduce the likelihood that military purchasers will benefit. Although military members already receive considerable low-cost life insurance as part of their government benefits, these companies' products usually provide small amounts of additional death benefits and survivors of some service members that died have received millions in death benefit payments from these companies. However, the products sold by these companies had much higher premiums than those that military members pay on policies offered by the government or other companies. In addition, these products raise concerns because they have a provision that depletes any accumulated savings to pay the insurance premiums if the military members, many of whom move frequently and leave the service within the first few years, ever stop making the scheduled payments. With state insurance regulators indicating that most military members halt their payments within the first few years and often fail to request refunds of their savings, most purchasers were left with little or no savings in exchange for a small amount of expensive insurance coverage. Insurance regulators and others have already taken actions to seek remediation on behalf of service members from several companies selling these products and additional investigations are underway in as many as 14 states. Regulators are examining allegations of whether representatives of these companies

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<sup>12</sup>Military Personnel Financial Services Protection Act, S. 418, 109th Congress (2005).

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misrepresented the products as investments rather than insurance, including investigating cases in which premiums for the products were alleged to have been fraudulently identified as going into savings accounts on forms used to deduct premium payments from the military members' pay. Information from our work, DOD, DOJ, and other organizations have documented that these companies have frequently been found to have violated DOD restrictions on selling products on military installations for years. During the course of our work, we also referred several potential fraud-related concerns to our special investigators, who have initiated contacts with federal law enforcement authorities, state insurance regulators, and DOD criminal investigative organizations.

Financial regulators have also found that a securities product known as a "mutual fund contractual plan" was also being widely marketed to military members.<sup>13</sup> Although rarely marketed to civilians since less expensive products have become widely available, securities regulators found that a small number of broker-dealers have been selling contractual plans that expect the purchaser to invest a set amount for a set period, such as 15 years. Although 50 percent of the contractual plan's first-year payments represent a sales charge paid to the selling broker-dealer, its total sales charges are generally less than for other load funds if held for the entire period. However, securities regulators found that only between 10 to 43 percent of the military members that purchased contractual plan funds completed their plans, and as a result, the majority of service members purchasing this product paid higher sales charges and likely received lower returns than had they invested in other available products. In addition to being less beneficial for those that stop making payments before completing the full term, regulators have also found that firms marketing contractual plans were using inappropriate sales practices. In a settlement reached with securities regulators in late 2004, the largest marketer of these contractual plans, a broker-dealer with nearly 300,000 clients, was censured for, among other things, using market materials that misrepresented the advantages of these plans compared to other

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<sup>13</sup>Contractual plans are legal investments referred to and regulated as "periodic payment plans" under Section 27 of the Investment Company Act of 1940. These plans allow investors to accumulate shares of a specified mutual fund indirectly by contributing a fixed amount of money on a regular basis for a specified period usually ranging between 10 and 20 years. An investor in a contractual plan does not directly own shares of a mutual fund. Instead, he or she owns an interest in the plan trust. The plan trust invests the investor's regular payments, after deducting applicable fees, in shares of a mutual fund. An investor in a plan has a beneficial ownership interest in those shares. For purposes of this report we refer to these plans as "contractual plans."

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investments. Investigations at other firms are continuing. Because these contractual plans have been periodically involved in sales scandals for decades, regulators questioned whether they should continue to be allowed to be sold, particularly since the innovations of the last 20 years have resulted in wide availability of lower-cost alternatives, such as no-load mutual funds and a government-provided retirement savings plan.

Financial regulators did not identify the problems occurring with sales to military members until they were brought to light by press reports for various reasons. Most state insurance regulators generally only conduct investigations of insurance company sales practices when they receive customer complaints. Although some state insurance regulators review insurance companies' product sales practices as part of market conduct reviews, few insurance products are subject to any suitability or appropriateness standards. However, DOD personnel were rarely forwarding service member concerns or complaints about potentially inappropriate insurance sales. As a result, insurance regulators in some states were not made aware of problems involving sales to military members. 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. In addition, prior securities regulatory examinations of the broker-dealers selling these products did not reveal problems because firms lacked standardized data on the extent to which their customers were successfully completing their contractual plans. Some state insurance and securities regulators also expressed concerns about whether they had clear jurisdiction over sales of financial products taking place on military installations. DOD is also attempting to improve its oversight of financial product sales on its installations, and has indicated that it plans to share additional information with financial regulators. However, it has not yet revised its policy relating to financial product sales to require its personnel to share information about service member concerns or complaints, or on violations of DOD policies by sellers of financial products. DOD was also reviewing various perceived barriers to sharing information, such as military privacy regulations, with external organizations, but has also not coordinated on procedures for overcoming these barriers with its installations or with financial regulators.

This report presents various matters for congressional consideration and includes recommendations to DOD and financial regulators. Given that service members already receive considerable low-cost insurance,

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Congress should consider directing DOD and requesting insurance regulators to develop standards applicable to the sale of insurance products to military members, and require that DOD take steps to improve its sharing of information with financial regulators. Given the availability of less expensive alternative products, Congress should also consider banning contractual plans. This report also includes recommendations to insurance and securities regulators to proactively seek information about sales to military members, and take other actions to improve the oversight of such products. We obtained comments on a draft of this report from DOD, NAIC, NASD, and SEC. Each of these organizations provided written comments expressing general agreement with our report and its recommendations (these comments appear in appendixes V through VIII).

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## **Sales of Costly Insurance Products to Service Members Raise Sales Practice Concerns**

A limited number of insurance companies that appear to target junior enlisted military members nationwide and around the world have sold certain costly, problematic insurance products, sometimes using inappropriate sales practices. These insurance products combine life insurance coverage with a side savings fund. The insurance products typically provide small amounts of death benefits and are considerably more costly than coverage offered to service members by the government or other private firms. Although they combine insurance with a savings component promising high returns, many military personnel did not benefit because any savings accumulated on these products can be used to extend the insurance coverage if service members ever stop making payments and fail to request a refund of their savings. A number of financial regulators are also investigating the claims that these companies have been using inappropriate sales practices when soliciting military members, including examining allegations that agents have been inappropriately marketing the insurance products as “investments.” Some of these companies have also been subject to past disciplinary actions by insurance regulators and for violations of DOD regulations governing commercial solicitation on military installations.

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## **Small Number of Firms Are Targeting Junior Military Personnel with Expensive Insurance Products with Adverse Provisions**

According to state insurance regulators we contacted, at least six insurance companies were marketing products combining insurance and savings funds with provisions that reduce the likelihood that military purchasers would accumulate any lasting savings with such products. These state insurance regulators are currently reviewing the operations of these companies. Several of these companies share common ownership,



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with three owned by the same firm and two others having key executives from the same family. These companies operate extensively throughout the United States, with four licensed to sell insurance in at least 40 states, and the other two licensed in at least 35 states. In addition, as of July 2005, DOD approved five of these companies to conduct business at U.S. military installations overseas.<sup>14</sup>

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.

### Products Couple High-Cost Insurance with a Savings Component Promising High Rates of Return

The insurance companies that target military service members are primarily marketing a hybrid product that combines a high-cost insurance policy with a savings component. According to insurance regulators we contacted, and company marketing materials that we examined, the insurance component generally consists of either a term or modified whole life policy that would provide death benefits generally ranging from \$25,000 to \$50,000 for premiums of approximately \$100 per month in the first year with different variations in the premium amounts for subsequent years, depending on the product. In addition to the insurance component, part of the total monthly payment is allocated to a savings fund. Based on our review of these products, most (or all) of the service member's payments in the first year are applied to the insurance component of the product. In subsequent years, more money is allocated to the savings fund to varying degrees, depending on the specific product.

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<sup>14</sup>Companies interested in selling insurance products on military installations overseas are required to apply to DOD each year for permission through its Overseas Life Insurance Accreditation Program. In order to gain authorization to conduct business in overseas installations, companies are to demonstrate continuous successful operation in the life insurance business for at least five years and must be assigned an acceptable rating from a private organization that assesses insurance company financial soundness.

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The companies marketing these products advertised that they paid relatively high rates of return on these savings funds. At the time we conducted our work, all of the companies were promising to pay 6.5 percent interest, or higher, on the savings fund portions of their products with a minimum of no less than 4 percent interest guaranteed. In contrast, as of August 30, 2005, the average national interest rate paid for a money market account was 2.16 percent.<sup>15</sup> Company officials also told us that in the past they had paid much higher interest rates. For example, one company's marketing materials for their product stated that over the past 25 years they had paid an average rate of 11.4 percent on the savings fund. Further, another company's marketing material stated that their saving fund interest rate for the past 10 years averaged over 10 percent.

The six companies that were marketing primarily to military members were selling two primary variations of these combined insurance and saving products. Three of the companies sold a product that provided 20 years of term life insurance. However, the premium payments for this product were structured so that purchasers would pay for the entire 20 years of life insurance coverage within the first 7 years. As a result, most of the service member's monthly payment for the first 7 years was allocated to the life insurance premium, not the savings fund. After the seventh year, all subsequent payments are to be deposited into the savings fund. In addition, this product also promised the full return of the total premiums paid for the insurance at the end of the 20<sup>th</sup> year, although state insurance regulators told us they were not aware of any policies that had reached this 20-year point and received this refund. Figure 2 provides an example of how the payments would be allocated for a service member purchasing this "7-year premium" term insurance product, assuming a monthly payment of \$100 and a savings portion crediting the guaranteed 4 percent simple interest paid annually.

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<sup>15</sup>Information on current rates obtained from *The New York Times* Business Section. *The New York Times* uses interest data provided by <http://www.bankrate.com>.

**Figure 2: Sample Payment Allocations of \$100 per Month for a Term Life Insurance Product Sold to Military Service Members with a 7-Year Premium Period and a Side Savings Fund Crediting 4 Percent**

Policy year	Annual insurance premium	Annual savings fund contribution	Accumulated value of savings fund
1	\$1,200	\$0	\$0
2	900	300	306.00
3	900	300	624.24
4	900	300	955.21
5	900	300	1,299.42
6	900	300	1,657.39
7	900	300	2,029.69
8	0	1,200	3,334.88
9	0	1,200	4,692.27
10	0	1,200	6,103.96
11	0	1,200	7,572.12
12	0	1,200	9,099.01
13	0	1,200	10,686.97
14	0	1,200	12,338.45
15	0	1,200	14,055.98
16	0	1,200	15,842.22
17	0	1,200	17,699.91
18	0	1,200	19,631.91
19	0	1,200	21,641.19
20	0	1,200	30,330.83 <sup>a</sup>

Source: GAO summary of sample product marketing material.

**Notes:**

For purposes of this illustration, we used a specific policy of a firm offering \$30,000 of life insurance coverage to a 20-year-old male coupled with a savings fund in which the insurance portion of the product is prepaid in the first seven years.

<sup>a</sup>Aside from interest credited in the side savings fund, the increased value of the fund at the end of year 20 includes \$6,600 that the company declares will be deposited into the fund representing the return to the purchaser of the total insurance policy premiums paid in the first 7 years (with no additional interest).

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Three other companies marketing primarily to military members sold other variations of the combined insurance and savings product. Generally, these products combined a modified whole life insurance policy with a savings fund. Under the basic terms of these products, most of the service members' first year's payments would be applied to the life insurance premium and the remainder allocated to the savings fund. From the second year on, the allocation proportions reverse where most of the money is applied to the savings fund. Premium payments on these products could continue for the life of the purchaser, although the face value of the death benefit would be reduced to half its initial amount after a certain period or when the policyholder reached a certain age, depending on the product. Figure 3 provides an example of how the payments could be allocated for a service member purchasing this type of product with a \$100 total monthly payment and 4 percent simple interest credited on the savings fund.

**Figure 3: Sample Payment Allocations of \$100 per Month for a Modified Whole Life Insurance Product Sold to Military Service Members with a Side Savings Fund Crediting 4 Percent (First 20 Years Shown)**

Policy year	Annual insurance premium	Annual savings fund contribution	Accumulated value of savings fund
1	\$900	\$300	\$306.00
2	300	900	1,236.24
3	300	900	2,203.69
4	300	900	3,209.84
5	300	900	4,256.23
6	300	900	5,344.48
7	300	900	6,476.26
8	300	900	7,653.31
9	300	900	8,877.44
10	300	900	10,150.54
11	300	900	11,474.56
12	300	900	12,851.51
13	300	900	14,283.61
14	300	900	15,772.95
15	300	900	17,321.87
16	300	900	18,932.74
17	300	900	20,608.05
18	300	900	22,350.37
19	300	900	24,162.39
20	300	900	26,046.88

Source: GAO summary of sample product marketing material.

Note: For purposes of this illustration, we used specific policies of a modified whole life product offered by two companies. A policy of one company provided \$25,000 of life insurance for a 28-year-old service member. The cash value associated with the insurance portion of the product was \$325 in year 4, \$1,142 in year 10, and \$2,706 in year 20. A policy of another company provided \$38,054 of life insurance coverage to a 22-year-old service member for the first 10 years, dropping in half to \$19,027 thereafter. The cash value of the insurance portion of the product was about \$57 in year 5, \$476 in year 10, and \$2,055 in year 20.

These insurance products also cost significantly more than other life insurance coverage available to service members. Prior to September 2005, all service members could purchase \$250,000 of term life insurance through SGLI for \$16.25 per month. Since September 1, 2005, the total coverage has increased to \$400,000 for \$26 per month. According to the Department of Veterans Affairs, which administers the SGLI program, 98 percent of all

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service members opt to receive this coverage. After leaving the service, service members can convert their SGLI coverage to a Veterans' Group Life Insurance (VGLI) policy which now also provides up to \$400,000 of low-cost term life insurance for veterans, with rates dependent upon age. For example, veterans between the ages of 40 and 44 years of age can purchase \$50,000 of life insurance for less than \$10 per month. In addition to government-sponsored coverage, service members can also purchase similar coverage, including covering combat deaths, from other insurance companies. For example, according to officials of one company that sells insurance and other financial products to military personnel directly, they could provide a 20-year-old service member an additional \$250,000 of life insurance to supplement SGLI for \$15 to \$20 per month.

In addition to being many times more expensive than other products already available to military members, companies have been selling insurance products to service members who generally do not appear to need additional life insurance, according to state regulators we contacted. These regulators also said the companies that targeted military members typically marketed their products to junior enlisted service members, who often have no dependents. During our review, we obtained data from the Defense Finance and Accounting Service (DFAS), which maintains military personnel pay records, indicating that most service members that appeared to have purchased life insurance products from some of these insurance companies had no dependents. For example, according to DFAS data on Marine Corps service members, over 6,500 pay deduction allotments to send premium payments to banks used by three of these insurance companies, starting between July 2004 and June 2005, indicated that approximately two-thirds were unmarried service members with no other dependents. Data available from other Services on allotments sent to these insurance companies during the same period also indicated that most of the service members had no dependents. Regulatory officials we contacted noted that the amount of coverage available to these members from SGLI would likely be adequate for their insurance needs, and thus no additional insurance coverage would be necessary.

Officials with one of the companies that targeted military members told us that the insurance they sell has benefited some service members. For example, their company has paid \$37 million in death claims for service members in the last 5 years, including \$1.5 million to survivors of service members killed in the recent conflict in Iraq.

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Certain Product Provisions  
Prevented Many Service  
Members from Receiving  
Favorable Investment Returns

The insurance products with combined insurance and savings components being sold by several companies to service members had provisions that reduced their benefits to purchasers that could not—or did not—pay into the product for a long-term period. According to regulators we contacted and our review of selected policies, the products being sold by at least six companies had an automatic premium payment provision, which allows the companies to use money accumulated in the service member’s savings fund to automatically pay any unpaid insurance premiums. The provision extends the period of time that the service member is covered under the life insurance policy if the service member does not proactively contact the insurance company to cancel the insurance policy and request a refund of the savings fund. After the automatic premium payment provision is triggered and the savings fund becomes depleted, the policy then terminates, or lapses. Regulators we contacted were critical of the impact that this provision can have on purchasers of these products. For example, an official at one state regulatory agency described this provision as allowing the company to “parasitize” the savings fund for its own benefit. In contrast, representatives of one company told us that this provision allows the service member to receive extended life insurance coverage.

Many military members that purchased these products only made their payments for a short period of time. State insurance regulators we contacted believed that most service members that purchased these products from these companies stopped making payments within the first few years, and that the lapse rates were significantly higher than industry norms. During our review, we received data on the percentage of policies that lapsed or terminated during the first year on products offered by four insurance companies that substantiated lapse rates above industry averages. For instance, information we obtained from one company that targets the military market segment indicated that approximately 40 percent of products purchased had lapsed or terminated within the first year. Data provided to us from three other firms indicated that the majority of policies had lapsed after being held between two and three years.

The characteristics of the military population that these companies were marketing to increases the likelihood that service members will stop making payments and not receive any savings they have accumulated in these products. Regulatory officials we spoke with said that one of the reasons so many service members discontinue making payments is that they leave the service and thus the automatic deductions of their premium payments to these companies also stop. Company officials we spoke with told us that service members ceasing payments can request and receive

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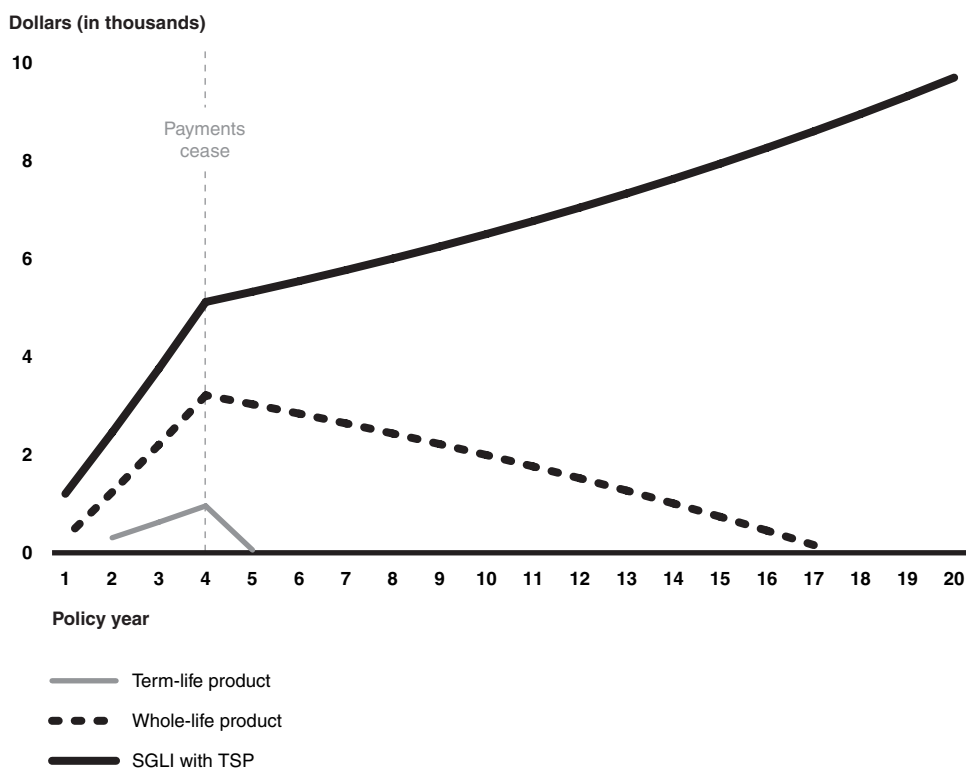
refunds of the amounts accumulated in their savings accounts. However, according to regulators we contacted, companies do not always receive such requests from service members at the time payments cease. According to these regulators, many service members may not have received refunds of any accumulated savings given that such funds are automatically depleted to pay for the insurance policy for an extended period until such amounts were exhausted. As a result, many of the service members who simply stop paying into the product likely did not receive any of the money they had paid into the savings portion of the product. As such, they obtained some extended life insurance coverage after their payments ceased that, as shown previously, was more expensive than insurance they already receive and that they would not likely have purchased except for the promised savings provision.

According to our analysis, the amount of time that it takes for a service member's savings fund on the products these six companies were selling with a monthly payment of \$100 to become totally depleted through the automatic payment provision varied. Figure 4 shows the impact on a service member that purchases the 20-year term life product with the 7-year premium period with \$30,000 of insurance coverage, makes \$100 monthly payments for 4 years totaling \$4,800, and then stops making payments. As the figure shows, the money in this service member's savings fund would be totally depleted to pay the subsequent insurance premiums in just over 1 year. This occurs because the policy requires that the entire 20 years of coverage be paid for in the first 7 years, which results in the monthly premium being larger than comparable policies. In addition, because almost all of the service member's payments during the first few years are allocated to the insurance policy, the accumulated value of the savings fund is modest. For the modified whole life product previously discussed, which required lower premium payments and larger savings accumulation after the first year, the savings fund of service members that ceased making their payments after 4 years would be sufficient 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—totaling \$92 for 4 years—and invest the remaining \$4,708 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.<sup>16</sup>

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



Source: GAO analysis.

<sup>16</sup>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 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.

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In addition to the high costs associated with the insurance portion of these combination products, other provisions diminished the value of the savings component as well. According to regulators we contacted, withdrawal penalties and unique methods of interest crediting significantly reduced the advertised rate of return for these products. Typically, service members withdrawing all or part of the accumulated money in the savings fund any time after purchase within the first 10 years would be assessed early withdrawal penalties. For example, one of the companies assessed an early withdrawal fee of 10 percent in the first year, with this fee declining by 1 percent each subsequent year until reaching zero in the 10<sup>th</sup> year. Several companies credit the amount accumulated on the basis of either the year-end balance or the average balance—whichever is less.<sup>17</sup> For sufficiently large withdrawals, a service member would not receive any interest at the end of that policy year on the money withdrawn from the fund. Under this methodology, amounts withdrawn during the year earn no interest, thereby reducing (in some instances significantly) the advertised rate of return.

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### Allegations of Improper Sales Practices often Associated with Companies Targeting Military Members

Insurance companies that market primarily to military members have been frequently accused of using inappropriate sales practices by regulators, DOD, and others. As part of our review, we identified at least 15 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 were accused of misrepresenting the products as investments or identifying themselves as representatives of independent benefit or fraternal organizations. (Appendix II lists these actions.) For example, in December 1998, two of the insurance companies that target military members settled a lawsuit filed by DOJ in Washington state that alleged that their agents had misrepresented their insurance policies as investment plans. As part of the settlement the companies had to offer refunds to approximately 215 service members in certain states who purchased life insurance policies between 1994 and 1997. In an agreement with the Attorney General's Office in the state in which one of the companies was domiciled, each of the companies also made \$1 million donations to a university in that state. More recently, after the Georgia Insurance and Safety Fire Commissioner initiated investigations to review allegations of improper insurance sales practices at military installations in that state,

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<sup>17</sup>End of year balance is the money accumulated in the fund during the policy year ending on the policy's anniversary date.

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two insurance companies have agreed to make refunds of about \$2.4 million to soldiers who had purchased insurance products.

After a series of articles in *The New York Times* raised concerns over sales of financial products to military members, state regulators in as many as 14 states began new investigations into the practices of companies that target service members.<sup>18</sup> According to regulators in these states, various sales practice concerns are being examined. As of September 2005, the investigations by these states generally had not been concluded. In addition to efforts by insurance regulators, law enforcement organizations and securities regulators are also reviewing the activities of some of the insurance companies that target military members.

One of the issues that is again a focus of regulators and others in their new investigations, is whether the companies and their agents were inappropriately marketing these products—not as insurance—but primarily as investment products. State insurance laws generally require any product with an insurance component to be clearly identified and marketed as insurance. However, regulators in various states raised concerns that the companies targeting service members were deemphasizing the insurance aspects of the product. Some state officials told us that the companies would have considerable incentive to obscure the insurance aspects of the product because 98 percent of service members already obtain a substantial amount of life insurance through the government-offered SGLI program. Insurance regulators we contacted told us that when marketing to military members these companies typically emphasize the investment provision of the products even though most, if not all, of the payments in the first year are used to pay the insurance premiums. Furthermore, most of this amount is then used by the companies to pay sales commissions to the selling agents.

The marketing materials for the companies that we examined also emphasized the savings component of the products. For example, a script from a sales presentation of one company mentions the insurance coverage third, after describing other product benefits. It also highlighted that the cost of the insurance was “free” if the service member completes the product terms. Insurance regulators with whom we spoke mentioned that

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<sup>18</sup>Diana B. Henriques, “Basic Training Doesn’t Guard Against Insurance Pitch to G.I.’s,” *New York Times*, July 20, 2004 and “Insurers Rely on Congress to Keep Access to G.I.’s,” *New York Times*, July 21, 2004.

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such a sales presentation is designed to overcome objections from service members that they did not need any additional life insurance. In addition, examiners in one state reported in 2002 that one of the companies' materials referred to the premium payments for the insurance product being sold to service members as "considerations" or "contributions," which were terms that they said were typically used when selling investment products. Our review of information provided by legal offices at Fort Benning, Georgia, and Great Lakes Naval Training Center, Illinois, also indicated issues related to insurance products being marketed and sold primarily as investment products.

The design of the products themselves may have also been misleading. Despite emphasizing the investment returns and high rates of promised interest earnings that were possible with these products, regulators in one state told us that the companies may have assumed that their actual policyholders would not generally attain these returns. As part of a class action case previously filed against one of these companies, presented as evidence were a series of internal company memorandums dating from around the time the company was proposing to begin selling a combined insurance and saving fund product. In one of these documents, a company official states the assumption that product purchasers would not earn the initially-promised 11 percent interest, or any amount even close to that, because the product's savings fund "is inextricably coupled with a rather expensive traditional life insurance policy," and has restrictive interest crediting and withdrawal provisions.

According to a deposition taken of a former company official, the company also assumed that many purchasers would not hold the product for very long. For example, this official stated that the company assumed that as many as 45 percent of purchasers would stop paying into the product within 1 year and another 25 to 30 percent would stop paying by years 2 and 3. In contrast, data from a service that tracks the rates at which insurance policyholders stop paying on their policies—called lapse rates—indicates that the lapse rate in the first year on term life policies requiring monthly premium payments averaged less than 15 percent.<sup>19</sup>

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<sup>19</sup>LIMRA International/Society of Actuaries, *Individual Life Insurance Persistence Study: Preliminary Results*, (March 2005).

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Other federal regulators are also investigating the extent to which the companies that market primarily to military members were marketing insurance as investment products. According to SEC officials with whom we spoke, insurance products marketed as investments may need to be registered as securities. Currently, insurance policies and annuity contracts issued by an entity subject to supervision by state insurance or banking regulators are exempt from securities registration.<sup>20</sup> Under existing case law, one factor that is important in determining whether an insurance product is entitled to this exemption is the manner in which the product is marketed.<sup>21</sup> Under a safe harbor created by SEC Rule 151, one condition for annuity contracts to avoid being subject to the federal securities laws is to not be marketed primarily as an investments. As of September 2005, SEC staff told us their inquiries into some of these companies' operations were continuing. In addition, DOJ officials also confirmed that they are investigating some insurance companies that market primarily to military members.

Officials with several of the companies that market primarily to military members told us that they clearly inform service members that the product they are offering is insurance. For example, officials at one of the companies showed us documents that they said are to be initialed and signed in multiple places by purchasers of their product that indicate that the product is insurance. An investigation by DOD personnel into sales at one naval facility indicated that many members knew they were buying insurance as well. However, an investigator of one of the states that previously sanctioned one of these companies told us that they had received information indicating that the company's sales agents may have found ways to present the products without the service members realizing they were buying insurance. Such allegations illustrate the difficulties that regulators face in determining whether inappropriate sales practices were being used.

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<sup>20</sup>Section 3(a)(8) of the 1933 Securities Act exempts from securities registration any "insurance policy" or "annuity contract" issued by a corporation subject to the supervision of an insurance commissioner, bank commissioner, or similar state regulatory authority.

<sup>21</sup>Another important factor is the allocation of investment risk between insurer and contract owner.

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Irregularities on Pay Allotment  
Forms Used for Deducting  
Premium Payments Being  
Investigated

Insurance regulators and other investigators are also investigating whether some of the companies have been misrepresenting the nature of the products in the forms used to initiate deductions for the premiums from service members' pay. According to DOD staff responsible for personnel pay systems, service members can have various types of allotments deducted from their pay, including deductions to be sent to savings accounts or to pay for insurance they purchase. However, for insurance allotments for junior enlisted members (those at rank E-3 and below), a 7-day "cooling off period" is required to pass before the allotment can be processed. Although these companies were selling insurance products, state regulatory officials we contacted were concerned that, in some cases, the companies were mislabeling the government pay deduction forms to reinforce the appearance that these purchases were investments and not insurance. For example, we reviewed pay allotment documents that appeared to indicate the service member purchasing this product was initiating a pay deduction that would be sent to a savings account in the member's name at a bank. In addition, the service member would also be asked to complete a form that authorized the recipient bank to withdraw the premiums due on the insurance product from the service member's account at that bank. However, state insurance regulators told us that the service members did not actually have accounts at these banks; rather, the money was deposited in a single account belonging to the insurance company. After we contacted officials at some of the banks to which these insurance companies were having service member payments routed, bank officials confirmed to us that the service members did not have accounts at the bank, but rather, contributions were sent to accounts belonging to the insurance companies. Thus, routing the payments to a bank with the allotment appearing as a bank allotment on the service member's pay statement, rather than an insurance allotment, could reinforce the impression that the service member had purchased an investment product rather than insurance. Insurance regulators in one state also told us that they found instances in which insurance agents were assisting service members to access online military pay systems to add allotments for insurance premiums.

Our own review found additional evidence of possible irregularities involving pay allotment forms and other activities by agents selling these combined insurance and saving products. During a review of documents used to initiate allotments from service members' pay at two military installations we visited, we also found several examples of allotment deduction forms that seemed as though the service member involved had a savings account at a bank used by the insurance company.

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We also noted several other potentially irregular activities. In some instances, insurance agents mailed allotment forms to the finance office that processes pay transactions for service members stationed at one of these bases using bank envelopes that had a bank's address as its return address. The use of bank envelopes could help convince base personnel that these were savings rather than insurance allotments, and thus not subject to any required "cooling off period." In another example of insurance company agents attempting to make the service member allotments used to pay for these insurance products appear to be savings allotments, we saw multiple instances of the use of an allotment form bearing the signature of the same bank official as the initiator of the allotment. After we contacted this bank official, he told us that he had once signed such a form but that the repeated use of the form with his signature was being done by the insurance agents without his knowledge. The results of these reviews and indications of potential fraud were referred to our special investigators, who are conducting further reviews and have initiated contacts with other law-enforcement organizations, DOD investigative agencies, and state regulatory departments.

Our review of allotment forms raised questions about whether agents marketing products targeting military members were encouraging service members to reduce tax withholdings and other savings contributions, thus providing a source of income to invest in the insurance products. Specifically, we found several examples of forms canceling service members' TSP contributions and altering the number of exemptions claimed on service members' W-4 forms (reducing the amount of tax withheld from their pay) that were submitted along with insurance allotment forms. Forgoing investment in TSP (which is generally recognized as being one of the lowest-cost ways to invest for retirement available anywhere) to purchase expensive insurance would not generally be in the service member's best interest financially. By reducing the member's withholdings and TSP contributions, the agents in these cases may have been attempting to overcome service member objections about affording the additional payment for the insurance product. In addition, reducing a service member's withholdings could potentially result in additional taxes due at year's end.

Concerns Exist over Whether Insurance Company Personnel Represent Themselves as Members of Other Organizations

Another sales practice issue that insurance regulators we contacted have been concerned about is whether some individuals that are selling insurance were not clearly representing themselves as insurance agents when marketing to military service members. In the past, DOD has found that insurance agents who have marketed to service members frequently

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identify themselves as counselors from benefits associations. Such entities provide counseling on obtaining government benefits or other services and may also offer their members discounts on other products, such as auto services. By representing themselves as benefits counselors, insurance agents may more readily gain access to service members.

However, regulators and others have documented prior instances in which insurance agents marketing to military members misrepresented themselves as benefits association employees. For example, in December 2002, DOJ announced a settlement against an insurance company that targeted military members whose agents had misrepresented themselves solely as employees of a benefits association. According to the DOJ complaint, this company had allegedly defrauded military service members who purchased life insurance policies from the company by having its agents pose as independent and objective counselors representing a non-profit fraternal organization that offered as one of its benefits the ability to purchase the company's life insurance.<sup>22</sup> However, the company's agents allegedly failed to disclose to the service members that they only were compensated through commissions from the insurance company, and that the company was making undisclosed payments to the benefits association for every policy sold. Under the terms of the settlement, the company agreed to, among other things, increase the face amount of all in force coverage by 6.5 percent, pay \$2.7 million to all service members who canceled their policies during a specific period, and to never again sell another insurance policy or reapply for DOD permission to conduct business on U.S. military installations.<sup>23</sup> According to a state insurance department investigation that was finalized in January 2002, agents from an insurance company that is currently being investigated by other states portrayed themselves as benefit association representatives without disclosing that they were insurance agents. As a result these agents were allowed to conduct military training during which they would solicit insurance to groups of service members. According to the report, the service members believed that the benefit association was part of the military establishment.

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<sup>22</sup>Complaint, *United States v. Academy Life Insurance Co.*, U.S. Dist. Ct., E.D. Pa., Civil Action No. 02-9125 (Dec. 19, 2000).

<sup>23</sup>Settlement Agreement, *United States v. Academy Life Insurance Co.*, U.S. Dist. Ct., E.D. Pa., Civil Action No. 02-9125 (Dec. 10, 2002).



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Regulators Are Reviewing Whether Some Insurance Product Sales Comply With State and Federal Laws

Another aspect of the operations of the companies that market primarily to military members that state insurance regulators were examining was whether the products comply with applicable state laws and regulations. For example, regulators in several states have been examining whether the saving funds that some of the companies had labeled as annuities may not actually qualify as such under their laws. After concerns arose about the sale of these combined insurance and savings products, insurance regulators in Washington state rescinded approval to sell the products that had previously been approved for sales by one of the companies that targeted the military in June 1997 and for three additional companies in October 2004. In taking these actions, the state's insurance department noted that it had determined that the savings fund provision of these products the companies were marketing were not properly structured to meet the requirements of this state's regulations pertaining to annuities.

Insurance Companies Targeting Military Members Also Frequently Accused of Violating DOD Solicitation Policies

In addition to raising concerns among financial regulators, the companies that target military members also have been accused of violating DOD's own solicitation policies. For example, 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 captive 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.<sup>24</sup> Last updated on August 11, 2005, this web site lists 21 agents from some of the 6 companies that are permanently barred—or have had their solicitation privileges temporarily suspended—at 8 different military installations.

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<sup>24</sup>See [http://www.commanderspage.dod.mil/dav/lsn/LSN/BINARY\\_RESOURCE/BINARY\\_CONTENT/1827481.pdf](http://www.commanderspage.dod.mil/dav/lsn/LSN/BINARY_RESOURCE/BINARY_CONTENT/1827481.pdf).

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Concerns over such violations are longstanding. For example, in March 1999, the DOD Inspector General also 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 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.<sup>25</sup> Similarly, a May 2000 report commissioned by the Office of the Under Secretary of Defense for Personnel and Readiness also reviewed insurance solicitation practices on DOD installations and identified many of the same concerns and recommendations as those the DOD Inspector General had identified.<sup>26</sup> As result of these two reports, DOD officials began efforts to revise its directive governing commercial solicitation on military installations.

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## A Unique Securities Product with High Sales Charges Sold to Military Members Has Also Raised Sales Practice Concerns

A few broker-dealers have marketed a unique securities product, often referred to as a contractual plan, to military service members that has proven to be more costly than other commonly available products. These contractual plans were primarily being sold by one large firm and several smaller firms that generally marketed only to service members. These products involve making periodic investments into a mutual fund under contractual agreements with much of the first year's investments going to pay a sales load that compensates the selling broker-dealer. Purchasers that make all required payments for the entire term of the contractual mutual fund plan would pay charges slightly less than the amount charged by other load funds. However, regulators found that most military purchasers were not making all required payments, resulting in them paying higher sales charges than would have been paid on other commonly available mutual funds. Regulators indicated that contractual plans are rarely sold to civilians and the products have been associated with sales practice abuses for decades. Regulators recently sanctioned the largest seller of these plans for inaccuracies in its marketing materials. Investigations into the activities of other broker-dealers selling contractual plans are also underway.

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<sup>25</sup>DOD, *Commercial Life Insurance Sales Procedures in DOD*, DOD Office of the Inspector General Report No. 99-106 (Arlington, VA: Mar. 10, 1999).

<sup>26</sup>DOD, *Final Report: Insurance Solicitation Practices on Department of Defense Installations*, Office of the Under Secretary of Defense for Personnel and Readiness (Washington, D.C. May 15, 2000).

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## Most Contractual Plans Were Sold in the Military Market by One Firm

Although being sold to large numbers of service members, contractual mutual fund plans were being marketed by only a few broker-dealers. SEC and NASD staff told us that their investigations have identified only about five broker-dealer firms that were marketing these plans. According to regulators, one of the broker-dealers accounted for over 90 percent of the \$11 billion invested in contractual plans as of year-end 2003. Unlike the insurance companies that targeted junior service members, this broker-dealer generally marketed its products to more experienced military members, including commissioned officers and senior noncommissioned officers.

According to its marketing materials, this firm had nearly 300,000 military customers, and indicated that one-third of all commissioned officers and 40 percent of active duty generals or admirals were clients. The firm 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. From January 1999 through March 2004, the firm received approximately \$175 million in front-end load revenue from the sale of contractual plans. Officials with the firm announced in December 2004 that they would be voluntarily discontinuing sales of contractual plans after being sanctioned by SEC and NASD.

The other four firms that continue to sell contractual plans were smaller broker-dealers. Of these, regulators told us that three also principally targeted military service members although, unlike the largest broker-dealer, these three firms generally sold contractual plans to junior enlisted personnel. According to regulators, the fourth broker-dealer appeared to be marketing to civilians. However, given the availability of other alternative low-cost mutual fund products in the marketplace that allow investors to make relatively small contributions on a regular basis, regulators indicated that they rarely see contractual plans being sold to civilians by other firms.

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**Contractual Payment Plans  
Feature High Up-Front Sales  
Charges that Are Not  
Typical of Other Securities  
Products Available**

Under the terms of the contractual plans being sold to military service members, the purchaser enters into a contract to make periodic investments for a set term (such as 10 to 15 years).<sup>27</sup> These payments are invested into funds offered by some of the largest mutual fund companies.

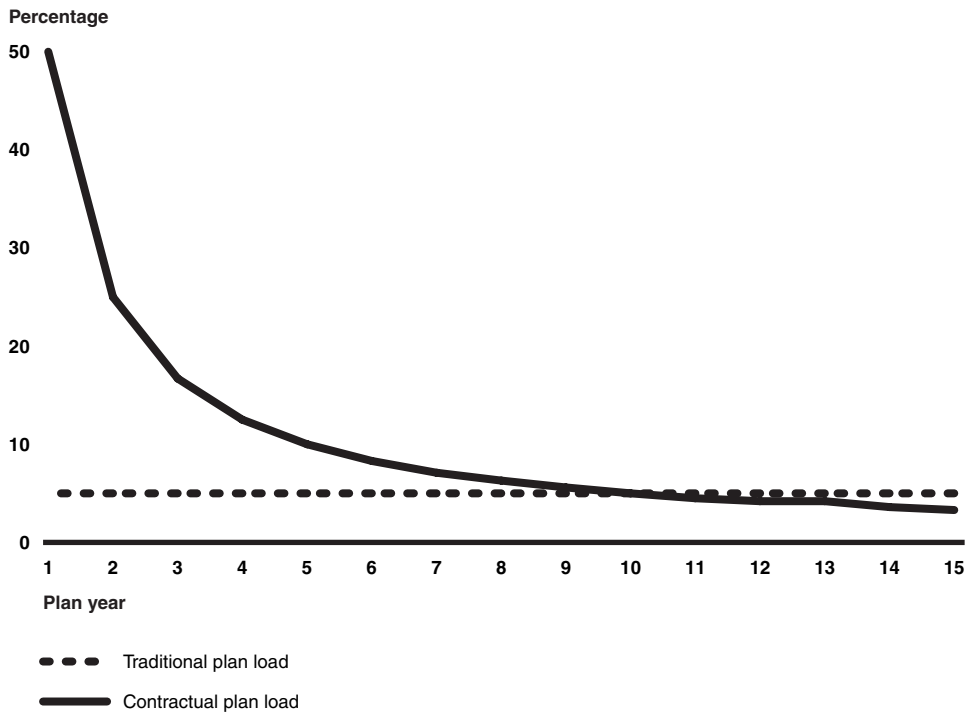
Under the contractual plan, the firm deducts a sales load of up to 50 percent from each of the first year's monthly payments but generally no further sales loads are applied thereafter. In contrast, a conventional mutual fund with a sales load will deduct a certain percentage—currently averaging about 5 percent—from each contribution made into the fund. 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.<sup>28</sup> As illustrated in Figure 5, if all 180 monthly payments are made under a contractual plan, the effective sales load on the total investment decreases to 3.33 percent by year 15.

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<sup>27</sup>Under the contractual payment plans commonly sold in the military market, the investor is to pay 180 fixed monthly installments (15 years), which may be extended to 300 payments (25 years) at the investor's option with no additional sales charge.

<sup>28</sup>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.

**Figure 5: 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. Regulators told us that in the past, many mutual funds required large initial investments that 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

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amounts of \$250 or less.<sup>29</sup> 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 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 through toll-free numbers, the Internet, or by mail.

According to industry participants, contractual plans provide their purchasers with the incentive to invest for the long term. Officials from the most active broker-dealer that marketed contractual plans told us that the larger upfront sales load encourages the investor to maintain a long-term investment plan because of the financial penalty that results from halting their payments too early. They also said that the contractual nature of the product helps purchasers make regular investments. In addition, these officials explained that the clients they serve are not high-income individuals with considerable accumulated wealth available for investment. As a result, they said that other broker-dealers do not provide financial services to these individuals. The officials from this firm said that their sales representatives spend many hours explaining the products and preparing and updating financial plans for their military clients. As a result, the higher up-front sales charge compensates their staff for the amount of time spent with clients. Officials from this firm told us that clients who purchased contractual plans and received financial plans from their firm generally benefited as the result of an improved financial condition overall.

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### Many Service Members Failed to Benefit from Contractual Plans

However, according to data obtained from securities regulators, many service members did not benefit from purchasing contractual plans. Although such plans can prove beneficial to an investor that makes all of the required periodic payments, regulators found that many service

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<sup>29</sup>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).

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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 largest broker-dealer had completed the full 15 years required under the contract. Instead, 35 percent of these clients that bought during this period had terminated their plans early. Another 22 percent had not cancelled their plans but were not making regular payments. According to securities regulatory staff, most of the clients that stopped making payments into this broker-dealer's contractual plans ceased doing so after about 3 years.

SEC staff told us that the customers of the other broker-dealers that were marketing contractual plans to military members had the same or even lower success rates of contracts completion. For example, they said that only about 43 percent of the clients of one of these broker dealers had made all required payments for a full 15-year period and, at another firm, just 10 percent of the customers had successfully completed a plan.

Because of the manner in which sales charges are assessed, terminating a contractual plan or halting payments early can greatly reduce the benefits to an investor. If the investor does not continue paying into the plan, the effective sales load can be much higher than industry norms. For example, as shown previously in Figure 5, an investor terminating after 3 years pays an effective sales load of 17 percent of the amount invested, which is more than three times the current average sales load in the mutual fund industry. As result, many of the service members that purchased contractual plans from these firms likely paid much higher sales charges than they would have under other alternative investments. Even if an investor makes all required payments under a contractual plan, we found that the amount accumulated on a contractual plan investment earning a 7 percent annual return is lower than that of a conventional mutual fund with a 5 percent sales load earning the same projected return until at least year 16 (this analysis is shown in appendix III).

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## Long Associated with Sales Practice Abuses, Firms Marketing Contractual Plans Again Raising Regulatory Concerns

Contractual plans have long been associated with sales practice concerns and recently regulators have taken action against the largest seller of these products. According to an SEC study, contractual plans to sell mutual fund securities were first introduced to the public in 1930.<sup>30</sup> However, concerns over the sale of these products, including excessive sales charges, arose and, as a result, the subsequently-enacted Investment Company Act of 1940 included a provision that limited the sales load that could be charged on contractual plans. After the passage of the Act, sales of contractual plans declined, with most of the companies selling such plans halting their marketing of such products.

However, during the 1950s and 1960s sales of contractual plans significantly increased. With researchers finding that many contractual plan purchasers were not continuing to invest in their plans, SEC recommended that the Investment Company Act of 1940 be amended to prohibit future sales of contractual plans. Although Congress chose not to ban contractual plans, it amended the Act in 1970 to increase protections for contractual plan investors. Specifically, Section 27 was revised to allow investors who cancel their plans within the first 18 months of purchase to obtain refunds on that portion of the sales charges which exceeds 15 percent of the gross payments made.<sup>31</sup> In addition, investors terminating their plan within the first 45 days could receive their full investment back with no sales charge deductions. Even with such limitations, sales charges associated with contractual plans can still be much higher than those of other mutual fund products and industry norms.

However, regulators again found inappropriate sales practices associated with contractual plans even after this provision was changed. For example, in the early 1990s, federal and state securities regulators took action against a broker-dealer, First Investors Corporation, for improper marketing of contractual plan investments, including its alleged failure to notify investors that they could invest in the same funds without having to pay the high sales charge required under the contractual plan. During this period, other low-cost mutual fund products emerged in the marketplace, allowing investors to make relatively small monthly payments into a mutual fund product with low fees. The contractual plan product generally

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<sup>30</sup>SEC, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966).

<sup>31</sup>Pub. L No. 91-547 §16, *codified at* 15 USC §80a-27(d).



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disappeared from the civilian marketplace but continued to be sold in the military market by a few firms, with one emerging as the dominant player in this niche market.

Recently, securities regulators have taken actions against a firm marketing contractual plans to military service members. In December 2004, SEC and NASD sanctioned the broker-dealer firm that was the dominant seller of such plans to service members. According to settlements reached with these regulators, the firm's marketing materials were alleged to have been misleading and to have inappropriately disparaged other viable investment options available to their clients. 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. The SEC and NASD settlements also alleged that the firm mischaracterized the contractual plan's high up-front sales load as the only way to ensure that purchasers remain long-term investors and presented comparisons of contractual plans using a holding periods of more than 14 years despite having data within the firm that showed that many of its customers were not successfully completing their plans. As a result, securities regulators found that the firm's service member clients paid higher than normal sales charges because they frequently did not continue making enough payments into such plans to reduce the effective sales charges to a level comparable to typical mutual fund sales charges in the industry.

The regulators also took action against the firm for inappropriate handling of customer complaints. As part of its investigation into this firm's practices, NASD sanctioned the firm for the actions of one of its supervisors who made improper statements to a service member who had previously expressed dissatisfaction with the broker-dealer. The regulatory settlement provides a summary of a call made to this customer in which the firm's supervisor appeared to threaten the service member with adverse consequences from his military superiors, including possible cancellation of his previously approved temporary duty orders.

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In settling with SEC and NASD, the broker-dealer agreed to pay a total of about \$12 million, including restitution to compensate customers who paid an effective sales charge of more than five percent on investments made since January 1999. As of October 6, 2005, \$4.3 million has been paid to investors. The remaining money is to be used to fund an educational program for service members that NASD will administer (this program is described later in this report). As previously stated, this broker-dealer announced that it has voluntarily discontinued sales of contractual plan products. SEC and NASD continue to investigate the other smaller broker-dealer firms that are marketing contractual plan products to military members and others. In addition, SEC staff also began conducting reviews of sales to military members in overseas locations and at installations in the United States. Two bills before the U.S. Senate (one of which passed the House of Representatives) would amend Section 27 of the Investment Company Act of 1940 to ban further sales of contractual plans.<sup>32</sup>

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## Lack of Complaint Sharing Prevented Earlier Identification of Improper Sales to Military Members

A lack of routine complaint sharing between financial regulators and DOD was the primary reason that regulators did not identify problematic sales of financial products to military service members before such issues were raised in press accounts, although other limitations among regulators' practices also contributed. Insurance companies are generally required to submit products for regulatory approval before marketing them but the review processes in most states may not have addressed the appropriateness of their features for service members. 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 some states had taken action, other state insurance regulators were not generally aware of problems involving military members until recent press reports, in part because DOD personnel were not usually sharing complaints or information about other inappropriate practices regarding the companies that targeted service members. However, we found evidence that concerns over inappropriate sales to service members exist widely at various military installations. Similarly, securities regulators also did not identify recent problems

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<sup>32</sup>S. 418, Sec. 3, and H.R. 458, Sec. 102.

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involving contractual plan sales to service members until such press accounts appeared. These regulators' ability to detect problems was also hampered by the lack of information on the extent to which broker-dealer customers purchasing contractual plans were successfully making their payments. In light of the problems surrounding sales of financial products to military members, DOD has efforts underway to revise its policies regarding such sales and has reviewed ways in which it could share additional information. However, DOD has not coordinated these efforts with military installation personnel or with regulators.

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**Without Complaints,  
Regular Insurance  
Regulatory Processes Did  
Not Identify Problems**

The product approval processes followed by many insurance regulators did not allow them to identify the products being marketed to military members as potentially problematic. One of the ways that state insurance regulators ensure that the products being sold in their states comply with insurance laws and regulations is through product approval requirements. Although insurance regulators in most states require insurance companies to submit products for approval before marketing them, state insurance officials in the states we contacted explained that the processes for approving products varied. In several of these states, insurance companies must submit products to the state regulators for reviews that are intended to assess whether the provisions and terms of the products comply with existing insurance regulations in those states. Companies sometimes submit additions to existing products, called riders, which change terms or provide additional features to their policies. However, according to some regulators in the states we contacted, the entire product may not be reexamined by their reviewers when such riders are submitted. In at least 2 states we contacted, different components of products sold to military members were filed and approved separately but then marketed and sold as a single product. For example, the savings fund of the insurance product being sold by four of the companies that target military members was submitted as a rider to a previously approved policy. However, regulators found that it was being sold as an integral part of the entire product, not as an optional feature to a life insurance policy. In at least one state we contacted, many insurance products are not reviewed but can be sold immediately upon filing notification with their department of the company's intent to market the products.

Additionally, insurance product approval processes may not necessarily reveal how a product is to be marketed or the target market for the product. According to officials in the state insurance departments we contacted, none of these states required insurance companies to provide

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descriptions of the target market for a particular product during the form filing process. As part of the investigations that state insurance regulators are conducting of the companies that target military members, some of the regulators are also reexamining the products these companies sell to ensure that they meet existing state requirements. For example, insurance regulators in Virginia issued an order in September 2005 to three companies to cease and desist from selling such products. However, the extent to which this review is occurring in other states is not clear.

Insurance Regulatory  
Examinations Generally Focus  
on Financial Soundness

State insurance regulators may conduct various types of reviews of the insurance companies they oversee. Many of the routine reviews that these regulators conduct focus on insurance companies' financial soundness. During such examinations, the regulators assess the quality of insurance companies' assets and whether their income is sufficient to meet present and future financial obligations to their policyholders.

Some state insurance regulators also review some aspects of insurance product sales as part of market conduct examinations. Designed to help protect consumers from unfair practices, market conduct reviews are done for a wide range of company practices, including sales, underwriting, and claims processing and payment.<sup>33</sup> For example, a regulator may review a sample of sales by a particular company to ensure that its agents have not misrepresented products or otherwise violated the requirements of their particular state. 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.

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<sup>33</sup>GAO, *Insurance Regulation: Common Standards and Improved Coordination Need to Strengthen Market Regulation*, GAO-03-433 (Washington, D.C.: Sept. 30, 2003).

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Many States Lack  
Appropriateness or Suitability  
Standards

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, when an insurance regulator receives a complaint or other information indicating that potentially problematic sales have occurred, they can review the marketing practices of any insurance companies involved to assess whether any misrepresentations or other fraudulent activities occurred. However, under most state insurance laws, insurance regulators do not have the authority to evaluate whether the product sold was appropriate or suitable given the customer's needs. In contrast, broker-dealers selling securities products are required to assess the financial circumstances of their customers to ensure that any products they recommend to these customers are suitable. Specifically, broker-dealers are required to consider such factors as their customer's income level, investment objectives, risk tolerance, and other relevant information.<sup>34</sup>

State regulators and others have tried to establish suitability standards for insurance products, but these efforts have generally not been successful. For example, in 2001, NAIC formed a working group to collect and analyze data, prioritize key issues for examination, and assess interstate cooperation in developing guidelines for market conduct standards. These market conduct standards would be intended to protect consumers from abuses in the insurance market, including those related to the availability and affordability of insurance. Using such standards, state insurance regulators would review the underwriting and marketing practices of insurance companies and their agents.

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<sup>34</sup>NASD Rule 2310, Recommendations to Customers (Suitability), states that in recommending to a customer the purchase, sale, or exchange of any security, a broker-dealer is required to have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." For example, recommending a product that poses a high risk of loss to an investor on a limited income could represent an unsuitable recommendation.

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However, after being unable to come to consensus on suitability standards that would apply to all insurance sales, the NAIC working group narrowed its approach. Instead, the group drafted a model law that provided standards for annuity products sold to seniors age 65 and over.<sup>35</sup> This draft model legislation would require that before insurance agents recommend the purchase or exchange of an annuity, they must take into account the purchaser's financial situation (including other investments or insurance policies owned) and reasonably believe that the recommendation is suitable for the purchaser. As of July 2005, NAIC reported that only nine states had fully or partially adopted this model law, 10 others already had similar or related legislation, and 35 states or territories had yet to take any action.

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.<sup>36</sup> After becoming IMSA qualified, a company's salesforce would be expected to assess a potential buyer's need for insurance before recommending its purchase. A representative of IMSA told us that insurance companies and agents following IMSA's guidelines for conducting a needs-based selling analysis would review a customer's insurable needs and financial objectives to determine the appropriate life insurance product, if any, to be offered. In many cases, junior service members with no dependents may not need additional life insurance beyond that available through the low-cost, government-offered SGLI. However, none of the six companies that were primarily marketing to military members with the combined insurance and savings product were IMSA qualified.

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<sup>35</sup>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.

<sup>36</sup>To become IMSA-qualified, an insurance company must conduct a self assessment of its ability to comply with IMSA's market conduct standards, which is reviewed by a Qualified Independent Assessor authorized to conduct an independent assessment of the company's policies and procedures on behalf of IMSA. A company must undergo the self and independent assessment every 3 years in order to retain its IMSA qualification.

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Legislation has been proposed that would require insurance regulators and DOD to work together to study ways to improve the quality of—and practices used to sell—life insurance products sold on military installations. For example, one option offered by these bills would be to only allow those companies that have met best practice procedures (such as those developed by IMSA) to sell insurance on military installations. These bills also propose that standards that would apply to the sale of products to military members could be developed.<sup>37</sup>

### Concerns and Complaints Existed at Military Installations

Although concerns or complaints involving insurance sales existed on DOD installations, insurance regulators we contacted mentioned that they generally have not historically received complaints from DOD officials about potentially problematic sales of products to service members. The actual extent to which service members have concerns or complaints involving insurance product sales is not known because, as we reported in June 2005, DOD only recently began systematically collecting information on violations of DOD's solicitation policy by sellers of financial products.<sup>38</sup> However, the DOD reports described earlier in this report, and work we conducted for this report and several other reports we recently issued, appears to indicate that concerns over inappropriate practices related to product sales among military members was widespread. For example, for our April 2005 report on the financial condition of military members, we surveyed 175 U.S. installation-level managers of DOD's personal financial management program, which provides service members with financial literacy training, financial counseling, and other assistance to avoid or mitigate the adverse effects associated with personal financial problems.<sup>39</sup> We reported in June 2005 that about 25 percent of the managers surveyed believed that insurance company representatives occasionally made misleading sales presentations at their installations during 2004, and 12 percent believed that such presentations were made routinely.

At the two bases visited as part of work for this report, we also found evidence that service members had concerns or complaints about the marketing practices used by sales personnel from some of the companies that targeted military members. After complaints were raised by some

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<sup>37</sup>S. 418, Sec. 9, and H.R. 458, Sec. 108.

<sup>38</sup>GAO-05-696.

<sup>39</sup>GAO-05-348.

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service members at these bases, military personnel conducted investigations of the matters. For example, at Fort Benning, Georgia, statements were taken from several service members that were solicited insurance products between 2001 and 2004. Of the 41 statements in the investigative files that we were able to review, more than 70 percent indicated that the sales personnel had described the product as a savings or investment product. Additionally, almost all of these service members indicated that the insurance company sales personnel had taken actions that violated one or more of the restrictions in DOD's solicitation policy, such as making these sales presentations during group training sessions.

At Great Lakes Naval Training Center, base legal advisers told us they do not receive many complaints because service members were often being solicited shortly before they transferred to other installations. However, legal staff at Great Lakes Naval Training Center showed us documentation related to 5 complaints pertaining to insurance products from service members between January and June 2005. In addition, they also indicated that they have also seen complaints arising from other military installations after leaving Great Lakes Naval Training Center. We also spoke with finance office personnel at this base who had become concerned about the sale of insurance to service members occurring there. As a result, these personnel had retained copies of some of the pay deduction allotment forms submitted for processing between June and September 2004. Numbering over 100, the copies represented forms that had been used to initiate pay deductions for products purchased by base service members from three different insurance companies, according to military pay personnel. We attempted to contact a random selection of these service members. We were able to speak with three of the service members and a spouse representing a service member who had purchased these products, and all indicated that the insurance product they had purchased had been generally represented as an investment.

However, state insurance regulators we contacted generally were not aware of the potentially problematic sales to military members because they generally were not receiving information about concerns or complaints from military personnel. These state insurance regulators and NAIC officials told us that they had received few complaints involving military members. For example, as part of our June 2005 report, we surveyed insurance regulators in 50 U.S. states and 4 territories and received 48 responses. Of these, regulators in only 8 states indicated that they had received life insurance related complaints from service members or on their behalf between October 2003 and December 2004.



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According to the director of the DOD office that oversees commercial solicitations on military installations, information about service member concerns or complaints involving financial product sales are not generally shared with state regulators for several reasons. In some cases, service members expressing reservations about purchasing one of these products might have received advice from other members or from superior officers to cancel, rather than complain to a regulator. In other cases, DOD officials told us that base personnel will work directly with the selling company to resolve a matter rather than involving a financial regulator. For example, a service member with concerns about a purchase of a financial product could consult with the installations' legal advisers from the judge advocate general staff. However, DOD officials stated that interactions between service members and these staff are covered by attorney-client privilege and thus are more difficult to share with external parties, such as financial regulators. Attorneys representing two state insurance departments believed that DOD attorneys should be forwarding such complaints because this would be in the best interest of the service members. They emphasized that complaints related to financial products should be forwarded to the financial regulators that can take action on behalf of the service members. They emphasized that failure to notify regulators that there are service members with concerns about financial product sales deprives regulators of important information necessary for their oversight processes to function properly.

In some cases in which military installations have reported concerns or complaints, regulators have been able to take action against insurance companies that conduct business with military service members. For example, regulators in Maryland were notified in the 1990s about potential improprieties involving sales of insurance products to junior enlisted personnel by a concerned official at one military training base in their state. In an examination report issued in January 2002, insurance regulators found that companies (including some of those that are currently being investigated by other states) marketing combined insurance and savings products to military personnel in Aberdeen Proving Grounds and other locations had violated various state laws and regulations and had misled some service members about the nature of the products, including misrepresenting insurance products as investments.<sup>40</sup> As noted previously, regulators in Washington state also became aware of problematic sales at

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<sup>40</sup>See *Maryland Insurance Administration Market Conduct Examination Report of Life and Health Business*, Report No. 490-01 (Baltimore, MD: Jan. 25, 2002).

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military installations in their state in the 1990s. This state eventually took action to rescind approval of certain insurance products where the side savings fund did not meet the state's requirements for an annuity, a premium deposit fund, or a universal life product. In addition, regulators in Virginia have also ordered that some companies that target military members to cease selling certain products in their state. However, regulators in the other states that are currently conducting investigations of the companies targeting military members were not generally aware of such sales until recent press reports because DOD personnel were not generally sharing information about any service member complaints or concerns they received.

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**Lacking Complaints and Data on Actual Customer Experiences with Contractual Plans, Securities Regulators Were also Unable to Identify Problems Involving Sales to Service Members**

Lacking information on complaints and data on the extent to which broker-dealer customers were successfully completing contractual mutual fund plans, securities regulators, similar to insurance regulators, also did not identify problems involving military members until press reports appeared. Although SEC and NASD, which has primary regulatory responsibility over the broker-dealers that were marketing contractual plans to service members, took enforcement actions against the firm that was the largest marketer of these products in late 2004, both regulators had conducted earlier examinations of this firm and did not identify any significant problems. SEC and NASD staff 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. However, NASD staff told us that after a DOD online periodical reported in 2003 that securities regulators were reviewing contractual plan sales, DOD staff received several inquiries from service members who had concerns about the products they had purchased. To the securities regulator staff, this provided evidence that concerns or complaints from military members were not being directed to the regulators—either by the service members themselves, or by the DOD personnel aware of such concerns.

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, in response to an article in *The Wall Street Journal* in 2002 that raised questions about the appropriateness of the sales of such plans to military members, SEC staff reviewed the

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operations of the largest seller of contractual plans.<sup>41</sup> According to SEC staff, their review did not raise any major concerns because they found no evidence that military members were complaining about their purchases from this firm. In addition, the firm provided the SEC staff with documents 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. The SEC staff told us that their examiners accepted these statistics as valid because they were also able to obtain data from one of the major mutual fund companies whose funds represented the majority of those in which this broker-dealer’s customers had invested. The data showed that most of this broker-dealer’s customers still had open plans with the company.

After an article that raised concerns about contractual plan sales to military members appeared in *Kiplingers*, a personal financial magazine, in 2003, NASD staff also initiated an examination of this broker-dealer.<sup>42</sup> According to NASD staff, although they had concerns over the sales of the contractual plan product, obtaining data on the extent to which the firm’s customers were continuing to make payments and successfully completing their plans was difficult, particularly since no specific requirement mandates that broker-dealers maintain records or standardized data. According to NASD staff, this firm maintained various sets of data on its contractual plan customers and becoming familiar with the differences in the information and determining what would be most useful for their reviews proved to be difficult and time consuming. They also noted that their existing examination procedures did not address issues such as persistency rates that were found to be relevant to examining contractual plans.

However, these regulators were able to identify concerns after they required the firm to provide comprehensive data on all customers that purchased such products. According to SEC and NASD staff, they were able to determine how successful this firm’s customers were being with their contractual plans only after they required the firm to provide specific data on all customers that purchased contractual plans covering a full 15-year period. After obtaining this data, regulators determined that the actual proportion of customers making all required payments for the 15-year term

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<sup>41</sup>Tom Lauricella, “Some Military Investors Bear a Heavy Load” *The Wall Street Journal*, C.1. (New York, N.Y.: Nov 27, 2002).

<sup>42</sup>Steven T. Goldberg, “Funds: A Marketer is Selling funds with Sky High Fees to Military Personnel,” *Kiplinger’s Personal Finance*, Volume 57, No. 9, p. 53 (Sept. 2003).

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of the plans was only 43 percent. This percentage was about half of the persistency or success rate shown in documents that the firm had previously provided to the regulators during their prior examinations, because the previously supplied data had excluded any customer whose account remained open but had not made any payments in the last year. However, in the view of regulators, investors that were no longer making payments into their plans should be taken into consideration when determining the overall extent to which a firm's customers were successfully completing their plans.

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### DOD also Taking Actions to Address Problematic Sales to Military Members, but Remains Reluctant to Fully Share Information with Financial Regulators

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. The primary way that DOD attempts to protect service members from inappropriate sales is through its directive on commercial solicitation on military installations. This directive, DOD Directive 1344.7, is administered by the Office of the Under Secretary of Defense for Personnel and Readiness. The directive currently places various requirements and restrictions on financial firms seeking to market products on military installations in the United States and overseas. For example, it prohibits sales from occurring as part of group meetings and instead requires financial institution personnel to make an advance appointment and meet with service members individually. In addition, sales personnel that are former military members are also prohibited from using their military identification to gain access to an installation. In the event that a company, its agents, or representatives violate DOD's solicitation policy, installation commanders can permanently withdraw the company's or individuals' solicitation privileges through a ban or can temporarily suspend those privileges for a specified period.

Following the DOD reports that detailed issues and concerns associated with insurance sales to military members, staff within the Office of the Undersecretary for Defense for Personnel and Readiness began efforts to revise DOD's solicitation directive. In April 2005, DOD sought public comments on a revised directive that incorporates new requirements. For example, the revised directive expressly prohibits insurance products from being sold as investments. In addition, it also includes a new evaluation form that is intended to be completed by each service member that has been solicited. The form would allow service members to indicate, with yes or no answers, whether the individual soliciting them violated certain aspects of DOD's policy, such as contacting them during duty hours. The evaluation form also has questions relating to salespersons' conduct during

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any solicitation, such as whether they pressured the service member into making a purchase, failed to provide adequate information, or implied that they were endorsed by the military.

In addition to revising its solicitation directive, DOD personnel have also taken enforcement actions against several insurance agents for improper solicitations at several military installations. For instance, at Fort Benning, an insurance company and its agents that operate in the military market segment were banned from conducting sales on the base. Additionally, several military personnel in supervisory positions were also disciplined for allowing improper insurance solicitations to occur and not properly enforcing existing solicitation policies.

DOD Lacks Requirements to  
Comprehensively Share  
Violations and Complaints with  
Financial Regulators

Although DOD has taken some steps to better protect its service members from inappropriate financial products, DOD does not currently require its personnel to share all relevant information with financial regulators, including complaints from service members. DOD's current policy regarding financial product solicitation only requires installation commanders to notify the appropriate regulatory authorities if they determine that an agent or company does not possess a valid license or has failed to meet other state or federal regulatory requirements. However, the draft of the revised solicitation directive includes provisions that would 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. The legislation being considered in Congress would also require DOD to maintain a list of names, addresses, and other appropriate information of any individuals selling financial products that have been barred, banned, or limited from conducting business on any or all military installations or with service members.<sup>43</sup>

DOD has already begun collecting and publishing information on actions taken by individual installations for violations of the solicitation policy. As noted previously, DOD has already consolidated this information from its installations and posted it on a web site. Under the legislation before Congress, DOD would also be required to promptly notify insurance and securities regulators of those individuals included or removed from this list. DOD officials have indicated that financial regulators can access the information about the actions taken against individuals or companies that

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<sup>43</sup>S. 418, Sec. 11, and H.R. 458, Sec. 110.

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have violated DOD solicitation policies from the web site and that, if these additional requirements become law, they will provide the information on their listing to financial regulators as it changes.

Although DOD is planning to share more information with financial regulators, DOD officials remained reluctant to share all information on violations of DOD policies that do not result in bans or suspensions. We recommended in our June 2005 report that DOD implement a department-wide searchable database to capture all violations of its own solicitation policy and provide this information to financial regulators. However, DOD officials told us that violations of some DOD policies, such as when sales personnel solicit without an appointment or solicit groups of service members, would probably not represent violations of financial regulations and therefore would be of little concern to such regulators. DOD officials also said that being required to report every time even minor violations occur, such as when a retired military member uses military identification to obtain base access for a solicitation visit, would be burdensome to their personnel.

However, financial regulators' staff told us that receiving information related to violations of DOD's commercial solicitation policies also would be very helpful in determining whether further action, such as revocation of licenses, was warranted. For example, officials from one state insurance department told us that insurance agents have the obligation to be trustworthy and that if such individuals are violating any DOD regulations, this information could help them determine whether the conduct of the agents also violate their state's requirements.

Although DOD personnel had not routinely shared service member complaints with financial regulators in the past, DOD officials have also told us that they intend to require their personnel to report more of that 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. However, staff in the office that oversees the policy directive told us that, as part of addressing the comments they have received, 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.

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Financial regulators indicated that receiving such information from DOD would greatly improve their ability to recognize and act on potentially problematic financial product sales involving service members. Insurance and securities regulator staff told us that promptly receiving concerns or complaints raised by service members would allow their normal regulatory oversight processes to function properly, which rely on complaints as an important indicator of potential problems involving insurance company or broker-dealer practices.

Congress also may be increasing the amount of information that both regulators and DOD have about potentially problematic practices by insurance sellers. Both of the bills currently under consideration in Congress would prohibit insurers from using agents that sell life insurance on military installations unless the insurer has a system to report to the state insurance regulators in its state of domicile and in the state of residence of an agent any disciplinary actions known to have been taken by any government entity and any significant disciplinary action taken by the insurer itself against an agent with regard to the agent's sales on military installations.<sup>44</sup> Furthermore, the bills would require that state insurance regulators develop a system for receiving such information and the ability to disseminate it to all states and to DOD.

However, some barriers appear to make sharing between DOD and financial regulators more difficult. As part of conducting their investigations of contractual plan sales, securities regulator staff told us that 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 they have researched these issues with their legal staff and 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 its own military installation personnel and financial regulatory staff understand how additional sharing could appropriately

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<sup>44</sup>S. 418, Sec. 10, and H.R. 458, Sec. 109.

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occur. In addition, to improve financial regulators' ability to obtain information from DOD, officials from NASD told us that the financial regulators could create liaisons on their staff to receive complaints and be the primary person responsible for seeking information from the military as part of examinations.

**Inadequate Financial Literacy  
and Lack of Jurisdictional Clarity  
Are also Concerns**

Although increased financial literacy could also help protect military service members from inappropriate financial product sales, concerns exist over the adequacy of such efforts to date. In a report on the extent to which consumers understand and review their credit reports, we noted that individuals' ability to understand credit matters differed across various demographic characteristics. For example, we found that college-educated individuals with high incomes and credit experience exhibited more expertise than those without such characteristics.<sup>45</sup> Similarly, many military members also tend to lack advanced education or high incomes. As our April 2005 report on the financial condition of military members noted, almost 40 percent of service members reported having some trouble managing their financial affairs and studies by private consultants have found that the overall financial literacy among service members is not high.<sup>46</sup>

DOD is attempting to increase financial literacy among military members. As noted previously, DOD has developed personal financial management programs to provide service members with financial literacy training, financial counseling, and other assistance to avoid or mitigate the adverse effects associated with personal financial problems. However, as we reported in April 2005, not all service members were receiving the training required as part of these programs. As a result, our report recommended that DOD implement a monitoring plan to ensure that all junior enlisted members receive the required personal financial management training.

Similarly, financial regulators have also begun working with DOD to increase financial literacy and awareness among service members, but these efforts have not been completed. For example, approximately \$7 million of the settlement that SEC and NASD reached with the largest broker-dealer selling contractual plans to military members will be used to

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<sup>45</sup>GAO, *Credit Reporting Literacy: Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts*, [GAO-05-223](#) (Washington, D.C.: Mar. 16, 2005).

<sup>46</sup>[GAO-05-348](#).



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fund financial education efforts among service members. Using the proceeds of the settlement, NASD staff told us that the staff of the NASD Investor Education Foundation plan to conduct research to determine current levels of service members' investment knowledge and use this to plan and develop its military education efforts. Among the efforts currently being designed are a military-specific online resource center to provide unbiased information on saving and investing. In addition, they plan to develop training to support the military's current personal financial management program by establishing a coordinated and uniform financial education program. They also plan to conduct a public outreach campaign to promote saving and investing to members of the military and their families. These efforts are anticipated to be publicly launched in late 2005 with many national and local activities taking place in 2006.

To help convey information to service members about insurance regulatory organizations outside the military that can receive and help resolve their complaints, NAIC and DOD staff have also been working together on materials to help educate service members. As of October 2005, their efforts have produced a consumer brochure for military members that contains information to help service members better understand factors to consider when purchasing life insurance and regulatory entities that service members can contact should they have complaints concerning insurance sales. According to NAIC officials, they are also working on information to be presented on a NAIC Web site.

Congress has also recognized the need for additional information to better protect military service members from inappropriate product sales. For example, both versions of the bill currently under consideration in Congress would require that, for any sales taking place on a military installation, insurance representatives disclose that subsidized life insurance may be available from the government to the service member and that the government has not sanctioned, recommended, or encouraged the sale of the product being offered.<sup>47</sup> In addition, this legislation also would require that service members be provided with information about where to complain regarding any problems involving an insurance sale on a military installation. Specifically, both bills would generally require that, for any sales taking place on federal land or facilities located outside the United States, insurance sellers provide a disclosure that lists the address

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<sup>47</sup>S. 418, Sec. 8, and H.R. 458, Sec. 107.

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and phone number where consumer complaints are received by the applicable state insurance regulator.<sup>48</sup>

Although DOD currently has a program to provide financial literacy training to junior personnel, not all levels of the services receive such information. Currently, the personal financial management training that the various branches offer to service members are provided only to junior enlisted members. However, an officer in one branch of the service also told us that she and other more senior members of the military are also solicited by financial firms and thus having such training, including addressing proper procedures for directing concerns or complaints, offered to more than just junior personnel would be helpful.

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."<sup>49</sup> For example, regulators from Maryland conducting work on a market conduct examination mentioned that they had asked an agent from the Federal Bureau of Investigation to accompany them when visiting the military installation in case installation personnel questioned the insurance regulators' authority to conduct an investigation on the installations. Further, according to a Texas insurance department official, he had trouble getting access to complaints information at a military installation because installation personnel question his authority to request such information. In addition, Georgia officials told us that a military installation in their state had an "exclusive federal jurisdiction" designation that could potentially present a jurisdictional issue. However, regulators in Virginia noted that they have been able to conduct examinations after seeking and obtaining written permission from base commanders. As part

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<sup>48</sup>S. 418, Sec. 8(b)(4), and H.R. 458, Sec. 107(b)(4).

<sup>49</sup>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.

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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.<sup>50</sup> 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.

While securities regulators also generally believed they had jurisdiction over sales on military installations, they too indicated that greater clarity would be beneficial. 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. 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 sales is generally applicable to any such activity 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 sales.<sup>51</sup>

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## Conclusions

Large numbers of military service members are being targeted by a few firms offering products that provide limited benefits unless held for long periods, which most military purchasers were failing to do. Thousands of service members across the United States and around the world are purchasing products from insurance companies that combine insurance and savings. 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 little need for any more coverage than that already provided by the low-cost government insurance service members receive. Instead, they were likely attracted to these products for their investment features. However, by being tied to expensive life insurance, these products appeared to be a poor investment choice for service members because they include provisions that allow the accumulated savings to be used to keep the life insurance in force if the service member ever stops making payments and

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<sup>50</sup>GAO 05-696.

<sup>51</sup>S. 418, Sec. 6(a), and H.R. 458, Sec. 105(a).

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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 request refunds, and as a result, few likely amassed any savings from their purchase. The few companies that sell these products also have been accused of using inappropriate sales practices in the past, have been sanctioned, and are again being investigated by numerous federal and state regulatory and law enforcement authorities.

With concerns over potentially inappropriate insurance sales to military members being longstanding, the need to take definitive actions to better protect service members appears overdue. The legislation that passed the House of Representatives and is being considered in the U.S. Senate includes various provisions that, based on our work, would appear to improve the protections for military members. Some of the provisions of these bills are of particular importance. Currently, both would direct insurance regulators and DOD to work together to develop measures to address sales to military members. Given that many service members were obtaining only limited benefits from purchasing these combined insurance and savings products, we believe that congressional action that results in state regulators undertaking reviews to ensure that only products that comply with state insurance regulations, an area in which regulators in some states now have developed concerns, is warranted to provide protections to military personnel in all U.S. jurisdictions. In addition, having insurance regulators and DOD work cooperatively to develop suitability or appropriateness 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, income levels, and likely inability to make payments for extended periods of time. This could also provide protection for service members that are located in overseas installations not directly overseen by state regulators.

Similarly, military members were also being widely marketed a securities product—the contractual plan—that has largely disappeared from the civilian marketplace. Although potentially providing returns equivalent to other products if steady investments are made over the required 15-year term, these products were likely less beneficial to the many service members that failed to make payments for that extended length of time. In the many years since contractual plans were first offered, a variety of alternative investments have become widely available for individuals with modest incomes, including other load funds, no-load funds, and TSP, which is now available to service members and likely offers the lowest investment

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expenses of any product. Given the longstanding history of sales practices abuses associated with the contractual plans and the availability of viable alternative investments, we believe that congressional approval of the legislation currently under consideration, which includes language to ban these products, would remove products that appear to have little need to continue to exist.

Although insurance and securities regulators have taken actions since allegations of inappropriate sales to military members have come to light, additional actions could mitigate some of the limitations that hampered regulators' ability to address these problems. As our work found, state insurance and securities regulators sometimes were uncertain of the adequacy of their authority over sales taking place on military installations. As a result, some of these regulators and officials from associations representing state insurance and securities regulators expressed support for congressional action to clarify that state financial regulators have jurisdiction over sales taking place in such locations.

In addition, congressional action could serve to better ensure that financial regulators are made aware of potentially inappropriate sales involving military members. As we found, federal and state insurance regulators' ability to more promptly identify inappropriate sales of financial products involving military members was hampered by the lack of information sharing by DOD. DOD officials have expressed their willingness to provide financial regulators with information on actions taken against individuals or firms that violate DOD's solicitation policies. They have also indicated their intention to require their personnel to provide information regarding service member complaints and concerns. However, they note that privacy requirements can pose perceived barriers to such sharing. In addition, they remain reluctant to share information about all instances in which sellers of financial products violate DOD solicitation policies. However, such information could allow financial regulators to determine whether such situations also represent potential violations of federal or state laws. As a result, we believe that congressionally-mandated direction is needed to ensure that DOD identifies ways to overcome these barriers and coordinates with its installation personnel and with financial regulators about ways to share additional information about problematic company behavior and service member concerns.

Additional DOD actions also could help protect service members from firms using unscrupulous sales practices. DOD officials have indicated that having their personnel share some information relating to service member

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concerns and complaints is appropriate. Including such a requirement in the revision of DOD's solicitation policy would better ensure that financial regulators receive this important information. DOD is also currently attempting to provide personal financial management training to improve financial literacy and competence among military members. Such training would also appear to be a useful forum for informing military personnel about proper procedures for submitting concerns or complaints. Given that more senior officers were customers of some of the financial firms that target military members, periodically providing such training to service members at all levels throughout the military would also likely raise awareness and assist them in making sound financial decisions.

Financial regulators also appear to have opportunities to improve their ability to protect military members from inappropriate sales. Because complaint information is a critical input to their regulatory processes, proactively seeking such information from DOD and its installations would likely improve regulators' oversight efforts. Given the uniqueness of the military environment, having staff or offices within regulators' own organizations that serve as liaisons with DOD and individual installations could allow both DOD and financial regulators to build trust and gain experience in sharing information and assisting investigations of potentially problematic financial product sales. Ensuring that financial regulators' staff also make use of any listings compiled by DOD of individuals or firms that have been sanctioned by the military for activities relating to financial product sales to target examination and investigation resources would also likely improve the protections that are afforded to military members.

SEC and NASD efforts to oversee broker-dealers marketing contractual plan mutual funds were hampered by a lack of standardized data at these firms on the success of clients in investing in these plans. In the event that such plans continue to be legally sold, having these regulators evaluate how best to ensure they will have such information in the future would improve their ability to oversee these products. Some possible ways to ensure such information is readily available would be to implement a rule requiring broker-dealers to maintain standardized records that show how successfully their customers are completing any contractual plans purchased. Alternatively, SEC and NASD examiners could routinely request such information prior to conducting a review of the broker-dealers selling these products.

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## Matters for Congressional Consideration

To better protect military service members from financial products with limited benefits to them, the Congress should consider taking the following five actions:

- Provide that products being marketed primarily to military members are reviewed by state insurance commissioners to ensure that all such product provisions are in compliance with existing state laws, and provide for reports through NAIC to relevant congressional committees on the results of these reviews within 12 months.
- Provide that state insurance commissioners work cooperatively with DOD to develop appropriateness or suitability standards for sales to military service members.
- Ban the sale of contractual mutual fund plans.
- Specify that state insurance and securities regulators have full access to persons and information necessary to oversee sales taking place on military installations or involving service personnel.
- Require DOD to work cooperatively with financial regulators to develop mechanisms that overcome existing barriers to sharing information about insurance and securities firm activities and service member concerns and complaints that can allow financial regulators to determine whether violations of existing federal or state laws or regulations are occurring.

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## Recommendations

To better protect service members from unscrupulous sales of financial products, the Secretary of Defense should take the following two actions:

- Issue a revised DOD solicitation policy requiring that information on service member complaints related to financial product sales be provided to relevant state and federal financial regulators.
- Include in the personal financial management training for all service members information and materials developed in conjunction with insurance and securities regulators that explains how and to whom service members should raise concerns or complaints about potentially inappropriate sales of financial products, including providing the

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information necessary for contacting these regulators. Such training should also periodically be offered to service members of all levels.

To better ensure that federal, state, and other financial regulators can oversee sales of insurance and securities products to military members, the heads of SEC, NASD, and state insurance and securities regulators should designate staff to receive complaints from DOD and conduct outreach with DOD headquarters and individual installations to proactively learn of issues or concerns regarding product sales.

These staff should also make use of any listings that DOD maintains of individuals or firms that have been sanctioned by the military for improper solicitation practices.

In the event that contractual mutual funds are not banned, the Chairman of SEC and the Chairman of NASD should consider various means of better assuring that their staff has adequate information to assess the sales of contractual plans.

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## Agency Comments

We provided a draft of this report to DOD, NAIC, NASD, and SEC for comments. Each of these organizations provided written comments expressing general agreement with our report and its recommendations (these comments appear in appendixes IV through VII). In concurring with our recommendation that DOD require that information on service member complaints be provided to financial regulators, a letter from DOD's acting principal deputy for the Undersecretary for Personnel and Readiness indicated that their revised solicitation directive will require installations to report such information to regulators. The principal deputy's letter also indicates they concur with our recommendation to provide all service members with information during personal financial management training on how to complain to regulators and states that they have developed a strategic plan for programs to assist members with determining appropriate financial products for their needs and how to remedy concerns or complaints. They also intend to approach state regulatory agencies to assist in providing educational information to all service members and provide such information during new comer orientations and through toll-free assistance lines.

In SEC's letter, the director of that agency's Office of Compliance Inspections and Examinations stated that they shared our concerns that securities products be properly marketed to military members. She also



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stated that in the event that Congress does not ban the sale of contractual plans they will consider our recommendation that SEC consider ways to ensure that it have adequate information to assess sales of such products. In NASD's letter, the NASD Chairman and Chief Executive Officer states that men and women of the U.S. armed forces deserve the same protection from inappropriate financial product sales as their civilian counterparts and that our report will help NASD and others to ensure that this is achieved. NASD's letter also describes the actions the organization has taken against the largest seller of contractual plans, including noting, as our report acknowledged, that they began reviewing this firm in 2003. NASD's letter also describes their efforts to develop education for military members.

In its letter, NAIC's Executive Vice President and Chief Executive Officer notes that we ask Congress to direct the states to review currently approved products being marketed to military members. In response, she indicates that a number of states are examining companies that have engaged in questionable practices involving these products and that an NAIC committee plans to review life insurance sold with a side fund to recommend a position on products being offered in the marketplace in 2006. Regarding our request that Congress direct DOD and the insurance regulators to work together to improve information sharing, NAIC's letter indicates that they are in the process of;

- compiling a list of insurance department contacts to ensure that DOD has the proper contact information for further state assistance;
- updating NAIC's Complaint Database System form to identify complaints that are submitted by military personnel; and
- providing 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.

Regarding our recommendation that DOD and regulators work together to develop training materials, NAIC's letter indicates that they have worked with DOD to develop a consumer brochure and a Web site specifically addressing life insurance information for military personnel and remain committed to developing other materials to fill any financial literacy needs that DOD identifies.

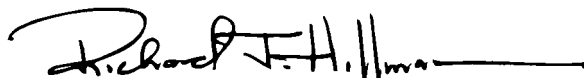
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We also received technical comments from each of these organizations that we incorporated where appropriate.

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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this report. At that time, we will send copies of this report to the Chairman and Ranking Minority Member, Senate Committee on Armed Services; Chairman and Ranking Minority Member, House Committee on Armed Services; and Chairman and Ranking Minority Member, House Committee on Financial Services. We will also send copies of this report to the Secretary of Defense, Chairman, SEC; and Chairman, NASD. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix VIII.



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

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# Objectives, Scope, and Methodology

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To identify the insurance products being sold and how these were being marketed to military members, we reviewed prior Department of Defense (DOD) reports, spoke to officials at the National Association of Insurance Commissioners (NAIC), and met with regulatory officials from several state regulators that are currently conducting or have previously conducted reviews of insurance companies that market primarily to military members. This work included interviewing regulatory officials and reviewing available documentation from the Georgia Insurance and Safety Fire Commissioner, the Texas Department of Insurance, the Florida Office of Insurance Regulation, and the Illinois Department of Insurance, and the Virginia State Corporation Commission Bureau of Insurance. In addition, we contacted staff from the Maryland Insurance Administration and the Washington Office of the Insurance Commissioner to discuss their past investigations of certain insurance companies targeting junior enlisted service members and reviewed documents pertaining to such investigations. We also visited Fort Benning, Georgia, and Great Lakes Naval Training Center, Illinois, to better understand the insurance solicitation issues present at two large military training installations. During these site visits we interviewed staff judge advocate personnel and reviewed documents pertaining to current and past investigations of sales of insurance products at these locations. Furthermore, we obtained data on the characteristics of military members making allotments to three different insurance companies in this market from DOD's Defense Finance and Accounting Service (DFAS), which maintains military personnel pay records. In our prior report, we were unable to reliably determine the total number of service members who have allotments for supplemental life insurance products or the number of dollars that service members pay to life insurance companies through the DFAS systems because not all allotments for insurance were identified as such. To provide accurate information for this report, we instead obtained from DFAS the dependent status of service members for allotments that were being routed to specific banks being used by some of the insurance companies that market primarily to military members, which produced results that we did believe were sufficiently reliable to highlight that a significant percentage of service members who had made allotments to specific companies had no dependents. Further, we contacted officials from the six insurance companies identified by the multistate investigation as being those companies that primarily market to service members, and reviewed their marketing materials for the product sold to service members.

To illustrate the cost and the possible performance of sample insurance policies offered by these companies we obtained and analyzed sample policies for a junior enlisted service member from six companies. We also compared the cost and performance of these products to other products offered to service members by the government including Servicemembers' Group Life Insurance (SGLI), Veterans' Group Life Insurance (VGLI), and the Thrift Savings Plan (TSP), as well as insurance products offered by a private insurance company. We chose the TSP G Fund as the savings component to be coupled with the government-offered insurance because of its low risk and its comparable return rate to the minimum rates claimed by the insurance companies. We assumed a 4 percent rate of return for all of our analysis based on the guarantee rate claimed on the policies typically marketed to service members by the six companies we reviewed. For approximating the projected TSP return, we compounded the 4 percent rate on a monthly basis. To project the return on the insurance products' savings components, we used the method of crediting interest in the products' terms, in which interest is credited on the lesser of the average balance during the year or the year-end balance. We also conducted analysis to illustrate the performance of the products after a service member stops making payments at the end of the fourth policy year. Further, the analyses we conducted are for illustrative purposes only and do not necessarily depict actual policy, plan schedules, or are adjusted according to various proprietary risk classes that could apply for a particular individual.

To identify the securities products being sold and how these were being marketed to military members, we interviewed staff from NASD (formerly called the National Association of Securities Dealers), Securities and Exchange Commission (SEC), and North American Securities Administrators Association (NASAA).<sup>1</sup> We also interviewed officials from the largest broker-dealer firm that markets to military members, which represents 90 percent of the military market segment, and two of the investment management firms that manage mutual funds underlying the contractual plans sold to service members. To determine the cost and performance of the contractual plan product offered by this broker-dealer firm, we conducted analysis to illustrate a contractual plan product typically marketed to career service members using a \$600 front-end load.

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<sup>1</sup>NASAA is a voluntary association representing 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

To illustrate how this product compared to other similar products we analyzed the cost and performance of a typical fund using the Investment Company Institute recommended 5 percent load and TSP C Fund with no load. We chose the TSP C Fund because it invests in common stocks and was therefore comparable to the contractual plan product. We analyzed these products for a 15 year--or "full term"--period. We assumed a 7 percent annual return that we compounded monthly for all products. Further, we reviewed SEC and NASD investigation files of the sales of securities products to military service members.

To assess how financial regulators and DOD were overseeing financial product sales to military members, we interviewed state insurance and federal, state, and other securities regulators. We also reviewed available materials pertaining to product approval, investigations, and regulatory activities and actions involving firms marketing to military members. Specifically, to assess how insurance regulators were overseeing sales of insurance products to military service members, we interviewed officials from NAIC, including the staff working on the multistate investigation of insurance sales involving service members. We also spoke with officials and reviewed available documents on activities and actions from several state insurance departments, including those in Florida, Georgia, Illinois, Maryland, Texas, and the state of Washington, that have previously investigated, or are currently investigating, companies targeting military members. Further, we reviewed legal actions taken against certain insurance companies as part of Department of Justice (DOJ) investigations and law suit cases.

To determine the extent to which state insurance regulators received complaints from military service members or had any concerns about their jurisdiction on military installations, we relied on an E-mail survey to the insurance commissioners for the 50 states, the District of Columbia, and four territories: American Samoa, Guam, Puerto Rico, and the Virgin Islands administered as part of our June 2005 report.<sup>2</sup> We received completed surveys from 46 states, the District of Columbia, and one U.S. Territory, yielding an overall response rate of 87 percent. Further, to make the same determination in regards to the sales of securities products to military members, we relied on the results of a survey administered by NASAA. Additionally, we contacted DOD officials, conducted fieldwork at Fort Benning, Georgia and Naval Station Great Lakes, Illinois—two large

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<sup>2</sup>See [GAO-05-696](#).

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**Appendix I**  
**Objectives, Scope, and Methodology**

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military training installations--and reviewed findings from other recent work concerning supplemental life insurance sales conducted at several other military installations throughout the country.

We performed our work from November 2004 to October 2005 in accordance with generally accepted government auditing standards.

# Actions Taken Against Financial Companies that Have Frequently Marketed to Military Members

Table 2 summarizes various actions that we identified during the course of our review that have been taken by regulators or others against companies that were identified as primarily marketing products to military members. As indicated, many of the actions were settlements in which the companies did not admit to any wrongdoing.

**Table 1: Regulatory Actions or Activities Involving Companies that Have Frequently Marketed to Military Members**

Entity taking action	Alleged violations	Resulting actions
Virginia State Corporation Commission Bureau of Insurance  September 2005  Cease and Desist Settlement Order, Case No. INS-2005-00211, Sept. 29, 2005	The regulatory forms for three insurance companies' combined insurance and savings product allegedly failed to comply with the state's insurance nonforfeiture laws.	The companies agreed to stop marketing or soliciting the particular products which failed to comply.
Georgia Commissioner of Insurance  May 2005  Commissioner of Insurance Press Release, May 25, 2005	An insurance company was investigated when allegations surfaced that certain agents violated various DOD and state insurance regulations by identifying themselves as disinterested financial advisors while selling policies to soldiers in training.	The company agreed to refund about \$1.1 million in premiums to soldiers who were solicited and sold term life insurance policies while they were training at two Army bases in Georgia.
Georgia Commissioner of Insurance  January 2005  Commissioner of Insurance Press Release, January 7, 2005	An insurance company was investigated when allegations surfaced that certain agents violated various DOD and state insurance regulations by identifying themselves as disinterested financial advisors while selling policies to soldiers in training.	The company agreed to issue refunds totaling about \$1.3 million to certain soldiers at an Army base in Georgia.
U.S. Securities and Exchange Commission and NASD  December 2004  SEC Administrative Proceeding File No. 3-11770, December 15, 2004  NASD News Release, December 15, 2004	A broker-dealer allegedly: <ul style="list-style-type: none"> <li>• offered and sold contractual plans by, in part, making misleading statements and omissions;</li> <li>• violated NASD rules when one of the company's supervisors inappropriately confronted a former customer who had made negative comments about the company; and</li> <li>• violated requirements to maintain books and records in connection with the retention and accessibility of certain E-mail communications.</li> </ul>	Without admitting any wrongdoing, the firm agreed to: <ul style="list-style-type: none"> <li>• accept a censure from NASD;</li> <li>• pay a fine of \$12 million, including about \$4 million for customer restitution and about \$8 million for an investor education program for members of the U.S. military and their families; and</li> <li>• hire an independent consultant to oversee the payment of restitution and review its sales practices.</li> </ul>

**Appendix II**  
**Actions Taken Against Financial Companies**  
**that Have Frequently Marketed to Military**  
**Members**

*(Continued From Previous Page)*

Entity taking action	Alleged violations	Resulting actions
Washington Office of Insurance Commissioner  October 2004	The regulatory forms for four insurance companies' combined insurance and savings products allegedly failed to comply with the state's insurance laws.	As a result of the withdrawal of approval of the forms, these companies' products could no longer be sold in the state of Washington.
Office of Insurance Commissioner Letter, October 21, 2004		
Department of Justice  December 2002  DOJ Press Release, December 19, 2002	The government alleged that an insurance company engaged in a scheme to defraud military members who purchased life insurance policies from the company between 1991 and 1998.	<p>The company agreed to settle the claims without admitting liability under the terms of a settlement agreement that the company:</p> <ul style="list-style-type: none"> <li>• pay a \$1 million civil penalty;</li> <li>• pay the U.S. \$505,965 to cover the costs of its investigation;</li> <li>• increase the face amount of all in-force coverage by 6.5%, for a total in-force increase in death benefits coverage of approximately \$160 million;</li> <li>• pay \$2.7 million to all policyholders who canceled their policies during the relevant time period; and</li> <li>• never again sell another insurance policy or reapply to DOD for permission to conduct business on military installations.</li> </ul>
Maryland Insurance Administration (Commissioner)  January 2001	<p>The agents for one insurance company allegedly:</p> <ul style="list-style-type: none"> <li>• did not disclose to military personnel that the products being sold were insurance;</li> </ul>	The company generally disputed the allegations but voluntarily agreed to, among other things:
Insurance Administration Market Conduct Examination Report No. 490-01, January 25, 2002	<ul style="list-style-type: none"> <li>• did not disclose to military personnel that they were insurance agents; and</li> <li>• misrepresented the product sold as something other than insurance.</li> </ul>	<ul style="list-style-type: none"> <li>• submit to the Commissioner the policies and procedures material for approval;</li> <li>• distribute the approved policies and procedures manual to its Maryland agency force; and</li> <li>• pay an administrative penalty to the state of Maryland in the amount of \$100,000, with \$50,000 suspended.</li> </ul>
Maryland Insurance Administration Consent Order, Case No. MIA-360-7/00 (January 7, 2001)		



**Appendix II**  
**Actions Taken Against Financial Companies**  
**that Have Frequently Marketed to Military**  
**Members**

*(Continued From Previous Page)*

Entity taking action	Alleged violations	Resulting actions
Florida Department of Insurance  February 2000  Florida Department of Insurance Consent Order, Case No. 23227-97-CO, February 17, 2000  Florida Department of Insurance Letter, April 5, 2000	Two insurance companies allegedly: <ul style="list-style-type: none"> <li>• failed to provide their customers with Buyers Guides and Policy Summaries;</li> <li>• failed to properly refund or escheat significant amounts of funds misdirected to the companies from the pay of military service members; and</li> <li>• improperly made unilateral reinstatements of lapsed policies.</li> </ul>	The companies generally denied the allegations but each voluntarily agreed to: <ul style="list-style-type: none"> <li>• look for and refund certain military members military pay allotments received by the companies;</li> <li>• set up and run a special Complaint and Alternative Dispute Resolution Program;</li> <li>• make a mandatory payment of \$200,000 to cover the costs of the investigation; and</li> <li>• contribute a gift of \$1 million to a Florida university.</li> </ul>
Department of Justice  December 1998  Complaint, U.S. Dist. Ct., W.D. Wa., Case No. C98-5211(Apr. 21, 1998)  Settlement Order, U.S. Dist. Ct., W.D. Wa., Case No. C98-5211RJB (Dec. 7, 1998)	The government alleged that two insurance companies: <ul style="list-style-type: none"> <li>• committed mail and wire fraud;</li> <li>• made false statements; and</li> <li>• conspired to defraud the United States.</li> </ul>	The companies denied the allegations but agreed to: <ul style="list-style-type: none"> <li>• not sell or market the life insurance product other than as life insurance;</li> <li>• abide by and observe all DOD directives and military regulations related to commercial solicitation on military installations;</li> <li>• conclude a comprehensive and final accounting of all funds paid to the companies in error, and provide a copy to the United States;</li> <li>• offer refunds of any unallocated moneys to payers who can be located through the exercise of due diligence; and</li> <li>• refund the full amount of all premiums paid by 215 specific individuals who requested a refund.</li> </ul>
Washington Office of Insurance Commissioner  June 1997  Office of Insurance Commissioner Letter, June 10, 1997	The product of an insurance company allegedly did not comply with the state's insurance laws.	Withdrew approval to sell the policies within the state of Washington.

**Appendix II  
 Actions Taken Against Financial Companies  
 that Have Frequently Marketed to Military  
 Members**

*(Continued From Previous Page)*

<b>Entity taking action</b>	<b>Alleged violations</b>	<b>Resulting actions</b>
United States Court of Appeals, Ninth Circuit  February 1997  108 F.3d 1123, (9th Cir. 1997)	Private claimants alleged that an insurance company violated the Racketeer Influenced and Corrupt Organizations Act (RICO) and committed fraud, and misrepresentation to facilitate sales of insurance as part of a tax avoidance scheme.	Appeals court affirmed jury verdict that the firm was liable for conspiracy to violate a provision of RICO in connection with a tax avoidance scheme. The jury awarded the plaintiffs: <ul style="list-style-type: none"> <li>• \$259,366 in actual damages (which were trebled pursuant to RICO);</li> <li>• \$87,000 in damages for fraud and negligent misrepresentation; and</li> <li>• \$500,000 in punitive damages under state law.</li> </ul>

Source: GAO analysis.

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# Performance of Contractual Plans Compared to Alternative Investments

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Because of the structure of their sales charges, contractual plans are not likely to offer superior returns to a long-term investor compared to other alternative products. Table 1 illustrates that investing \$100 per month for 15 years in a contractual mutual fund plan that earns a 7 percent return would result in an account worth less than one in a conventional mutual fund with a 5 percent sales load in which the same payments were made and the same projected return was earned. As shown in the table, the amount that would be accumulated in a contractual plan does not exceed that of a conventional mutual fund until after 16 years. The contractual plan's accumulated value lags behind the conventional fund because its high up-front sales charge reduces the amount of money that is invested and available to earn the return of the underlying mutual fund from the beginning. In contrast, investing \$100 monthly in TSP and earning a 7 percent return would result in an account worth \$1,600 more than that accumulated in the contractual plan after 15 years.<sup>1</sup>

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<sup>1</sup>For projected return rates of below 7 percent, the amount earned on the contractual fund plan would exceed that of the regular 5 percent load fund sooner, but for returns of greater than 7 percent, the contractual plan would require more than 15 years to exceed the 5 percent load fund's accumulated amount. Because TSP does not charge sales charges, its accumulated amounts would always exceed those of the other two investments by increasingly larger increments as the projected return rates are increased. We used TSP C Fund for this calculation because it invests in common stocks and was therefore comparable to the contractual plan product.

**Appendix III  
Performance of Contractual Plans Compared  
to Alternative Investments**

**Table 2: Investment Performance of a \$100 Monthly Contribution into a Contractual Plan, Conventional Mutual Fund, and TSP C Fund, Assuming Each Earns a 7 Percent Return**

Payment contributions		Contractual Plan (50% load)		Conventional mutual fund (5% load)		Thrift Savings Plan C Fund (No load)	
Policy year	Yearly payments	Sales load	Total value	Sales load	Total value	Sales load	Total value
1	\$1,200.00	\$600.00	\$623.24	\$60.00	\$1,184.16	\$0.00	\$1,246.49
2	1,200.00	0.00	1,914.79	60.00	2,453.93	0.00	2,583.08
3	1,200.00	0.00	3,299.69	60.00	3,815.49	0.00	4,016.30
4	1,200.00	0.00	4,784.72	60.00	5,275.47	0.00	5,553.13
5	1,200.00	0.00	6,377.09	60.00	6,841.00	0.00	7,201.05
6	1,200.00	0.00	8,084.58	60.00	8,519.70	0.00	8,968.10
7	1,200.00	0.00	9,915.50	60.00	10,319.75	0.00	10,862.90
8	1,200.00	0.00	11,878.78	60.00	12,249.93	0.00	12,894.66
9	1,200.00	0.00	13,983.99	60.00	14,319.64	0.00	15,073.31
10	1,200.00	0.00	16,241.38	60.00	16,538.97	0.00	17,409.45
11	1,200.00	0.00	18,661.96	60.00	18,918.74	0.00	19,914.46
12	1,200.00	0.00	21,257.52	60.00	21,470.54	0.00	22,600.57
13	1,200.00	0.00	24,040.71	60.00	24,206.81	0.00	25,480.86
14	1,200.00	0.00	27,025.11	60.00	27,140.89	0.00	28,569.36
15	1,200.00	0.00	30,225.24	60.00	30,287.07	0.00	31,881.12
16	1,200.00	0.00	33,656.71	60.00	33,660.69	0.00	35,432.30
17	1,200.00	0.00	37,336.25	60.00	37,278.18	0.00	39,240.19
18	1,200.00	0.00	41,281.77	60.00	41,157.19	0.00	43,323.36
19	1,200.00	0.00	45,512.52	60.00	45,316.61	0.00	47,701.69
20	1,200.00	0.00	50,049.12	60.00	49,776.71	0.00	52,396.54

Source: GAO analysis.

Note: If the conventional mutual fund offers breakpoints, which are discounts on the sales loads to investors who invest certain amounts of money such as investments over \$25,000, the investor would earn even more with a conventional load fund due to lower sales charges for investments of that amount.

As table 1 also shows, investors that terminate their periodic investments earlier than the full 15 years are even more likely to be better off with a conventional mutual fund or TSP. For example, an investor ceasing payments after 4 years in the contractual plan would have an account worth about \$4,785. However, after 4 years, the account of the conventional mutual fund would be worth almost \$5,275 and the TSP account would be worth about \$5,553.

# Jurisdictions in Which at Least One of the Six Insurance Companies That Target Military Members Were Licensed to Sell Insurance

Alabama	Missouri
Alaska	Montana
Arizona	Nebraska
Arkansas	Nevada
California	New Jersey
Colorado	New Mexico
Connecticut	North Carolina
Delaware	North Dakota
District of Columbia	Ohio
Florida	Oklahoma
Georgia	Oregon
Hawaii	Pennsylvania
Idaho	Rhode Island
Illinois	South Carolina
Indiana	South Dakota
Iowa	Tennessee
Kansas	Texas
Kentucky	Utah
Louisiana	Virginia
Maryland	Washington
Massachusetts	West Virginia
Michigan	Wisconsin
Minnesota	Wyoming
Mississippi	

Source: NAIC data.

# Comments from the Department of Defense



PERSONNEL AND  
READINESS

OFFICE OF THE UNDER SECRETARY OF DEFENSE  
4000 DEFENSE PENTAGON  
WASHINGTON, D.C. 20301-4000


OCT 21 2005

Mr. Richard Hillman  
Director  
Financial Markets and  
Community Investment  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Hillman:

This is the Department of Defense (DoD) response to the GAO draft report, GAO-06-23, "FINANCIAL PRODUCT SALES: Actions needed to Better Protect Military Members," dated September 29, 2005 (GAO Code 250166). The Department's responses to the report's two recommendations are enclosed.

Sincerely,

  
Gail H. McGinn  
Performing the Duties of  
the Principal Deputy

Enclosure:  
As stated

GAO DRAFT REPORT DATED SEPTEMBER 29, 2005  
GAO-06-23 (GAO CODES 250166)

"FINANCIAL PRODUCT SALES: Actions  
Needed to Better Protect Military Members"

DEPARTMENT OF DEFENSE COMMENTS  
TO THE GAO RECOMMENDATION

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense revise the DoD solicitation policy to require that information on servicemember complaints related to financial product sales be provided to relevant state and federal financial regulators.

DOD RESPONSE: Concur. Existing DoD policy requires installations to report matters concerning the eligibility of an agent or company to hold a State license or to meet other regulatory requirements to appropriate authorities. The revised Directive will include a requirement for installations to report concerns or complaints involving the quality or suitability of financial products and concerns or complaints involving marketing methods used to sell these products to DoD personnel to the appropriate regulatory agency. ECD: January 1, 2006

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense include in the personal financial management training for all servicemembers information and materials developed in conjunction with insurance and securities regulators that explains how and to whom servicemembers should raise concerns or complaints about potentially inappropriate sales of financial products, including providing the information necessary for contacting these regulators. Such training should also periodically be offered to servicemembers of all levels.

DOD RESPONSE: Concur. DoD Instruction 1342.17 on Personal Financial Management Programs for Service Members, requires all entry-level Service members be able to demonstrate competency on several topics concerning personal finance, to include insurance, savings and investing. DoD has developed a strategic plan to develop programs and systems designed to assist them in becoming capable of discerning what is appropriate and inappropriate for their needs and how to remedy concerns or complaints arising from suspect sales of financial products. An important aspect of the proposed approach will be evaluating their competency to ensure the intended lesson has been learned. DoD Instruction 1342.17 further instructs the Military Services to make information and instruction available to support the life events of Service members and their families. The intent of this policy is to support Service members and their families in making decisions affecting their personal finances as their individual/family circumstances change, based on the basic competencies obtained at entry level. DoD has obtained the assistance of several

federal agencies and nonprofit organizations in accomplishing this information and education requirement, to include the National Association of Securities Dealers Foundation. As part of this on-going effort, DoD will approach state regulatory agencies to assist in providing awareness and educational materials to assist in making Service members and their families aware of their rights and opportunities to seek remedy. Among other opportunities for increasing awareness, installation-level new comers orientations and the Military OneSource toll free assistance line will be used to enhance awareness and direct Service members and their families to assistance resources. ECD June 30, 2006



# Comments from the Securities and Exchange Commission



OFFICE OF COMPLIANCE  
INSPECTIONS AND  
EXAMINATIONS

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

October 20, 2005

Richard J. Hillman  
Director, Financial Markets and Community Investment  
United States Government Accountability Office  
Washington, DC 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on your draft report concerning Financial Product Sales, Actions Needed to Better Protect Military Members. We share your concerns that securities products be properly marketed and sold to members of the military. As your report describes, SEC examinations and enforcement investigations have revealed unsuitable sales of financial products to members of the military. As a result, the SEC and the NASD brought an enforcement action against *First Command Financial Planning, Inc.* (Admin. Proc. File No. 3-11770). The SEC staff has also established ongoing contact with the Department of Defense, and initiated two examination sweeps focusing on broker-dealer firms that sell securities products to military personnel and that maintain sales offices located near large military facilities. These examinations are ongoing.

We wish to emphasize the level of productive cooperation in our dealings with personnel in the Department of Defense. Staffs of the SEC and Department of Defense have established regular meetings to share information and discuss issues as they relate to securities sales to the military. As part of this cooperation, Department of Defense staff has provided us with key information that has helped us target particular securities firms for examination. This cooperation has also extended to base commands, including overseas base commands. Finally, Department of Defense and base staff have been working with us to identify complaints regarding abusive securities sales and to establish procedures whereby future complaints can be brought directly to our attention.

Your report also recommends that, in the event that contractual mutual funds are not banned by Congressional action, the SEC and NASD consider various means of better ensuring that regulators have adequate information to assess the sales of contractual plans. We will certainly consider this recommendation.

We appreciate the GAO's attention to these important issues.

Sincerely,

A handwritten signature in black ink, appearing to read "Lori Richards", written over a white background.

Lori A. Richards  
Director

# Comments from NASD (Formerly Called the National Association of Securities Dealers)

Robert R. Glauber  
Chairman and Chief Executive Officer

October 18, 2005



The Honorable David M. Walker  
Comptroller General of the United States  
U.S. Government Accountability Office  
441 G Street NW  
Washington, DC 20548

Dear Mr. Walker:

NASD appreciates the opportunity to comment on GAO Report 06-23, "FINANCIAL PRODUCT SALES: Actions Needed to Better Protect Military Members." Men and women of the U.S. armed forces deserve the same protection from inappropriate sales of financial products as their civilian counterparts. This report will help NASD, other financial regulators, and Congress ensure that such is the case. In addition to the technical comments we have already provided, NASD would like to make the following more general comments.

#### Background on NASD

NASD is the leading private-sector provider of financial regulatory services, dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. NASD touches virtually every aspect of the securities business - from registering and educating all industry participants, to examining securities firms, enforcing both NASD rules and the federal securities laws, and administering the largest dispute resolution forum for investors and member firms.

#### Summary of First Command Investigation and Settlement

In December 2004, NASD censured First Command Financial Planning Inc., a Fort Worth, TX broker-dealer, and imposed a fine of \$12 million for making misleading statements and omitting important information when selling mutual fund investments. In particular, the misleading statements and omissions were made in connection with Systematic Investment Plans sold primarily to commissioned and non-commissioned military officers. Under Systematic Investment Plans, an investor makes monthly payments for a fixed term, typically 15 years, and those payments are invested in underlying mutual funds. The purchaser is charged a 50 percent sales load on the first twelve payments. Over the remainder of the term, payments are not subject to sales charges so that the effective sales charge decreases so long as the purchaser continues to make additional investments. However, if the investor does not terminate within 45 days, and then fails to complete the term, he or she will pay a sales charge of up to 50 percent of the amount invested.

Investor protection. Market integrity.  
1735 K Street, NW tel 202 728 8040  
Washington, DC fax 202 728 8075  
20006 www.nasd.com

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**Appendix VII**  
**Comments from NASD (Formerly Called the**  
**National Association of Securities Dealers)**

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October 18, 2005  
Page Two

NASD found that First Command emphasized in its sales scripts that the 50 percent sales load would decrease to 3.3 percent upon completion of the term and that the high up-front sales charges increased the likelihood that an investor would complete the plan. However, the firm's own data showed that only 43 percent of its customers completed the 15-year term. First Command also failed to inform its customers of the lost earnings potential as a result of the sales charges deducted from the customer's first 12 months' investments. First Command also made misleading statements when comparing the Systematic Investment Plan with other mutual fund investments.

From the \$12 million fine, First Command was ordered to pay restitution to thousands of customers who purchased a Systematic Investment Plan after January 1, 1999 and who terminated the plan and paid an effective sales charge greater than 5 percent. As of today, over \$4.3 million has been returned to this class of customers. The remainder of the \$12 million dollar payment, after restitution payments have been completed, is payable to the NASD Investor Education Foundation, to be used for financial education needs of United States military personnel and their families. In addition to making these payments, First Command was required to hire an independent consultant to oversee the payment of restitution and review its sales practices.

NASD would like to comment on the statement in the report that "financial regulators did not identify the problems occurring with sales to military members until they were brought to light by press reports for various reasons." As the report notes, securities regulators including NASD often rely on customer-initiated complaints to undertake investigations and enforcement actions. In this case, NASD began investigating potential misconduct by First Command and its representatives in August of 2003, immediately after an article about First Command appeared in Kiplinger's and before receiving any complaints from military personnel or the Department of Defense about investment products sold by First Command. NASD initiated this investigation well before a series of articles was published in the New York Times in July 2004 regarding sales of insurance products and securities products to military personnel.

Summary of Military Financial Education Campaign

First Command has made payments to the NASD Investor Education Foundation, to be used for the financial education needs of members of the military and their families. Established in 2003, the NASD Investor Education Foundation supports innovative research and educational projects that give investors the tools they need to better understand the markets and the basic principles of saving and investing. To date, the Foundation has granted more than \$5 million to non-profit organizations for educational programs and research projects targeting underserved segments of the population.

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**Appendix VII  
Comments from NASD (Formerly Called the  
National Association of Securities Dealers)**

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October 18, 2005  
Page Three

The Foundation is using the funds it receives in connection with the First Command settlement to support educational programs, materials and research to help equip members of the military community with the knowledge and skills necessary to make informed financial decisions. We anticipate that the Foundation will receive approximately \$7 million.

These funds will be used to mount a comprehensive financial education program with the goal of improving the saving and investing knowledge of military families. This will include a Web site devoted to financial education issues for the military, a continuing investor education program for base installation personal financial managers, financial counselor certification for military spouses, and development of materials such as a guide to the financial decisions surrounding deployments. Beginning early next year, the Foundation will hold investor forums and other educational events at three or more primary military installations, at which specially prepared educational materials will be distributed. As the year progresses, this will be supplemented by events and activities at installations across the country. Not only does the Foundation intend to educate active duty military personnel, it intends to provide organizational and technical assistance targeted to spouses and military family service organizations so that financial education can be provided on an ongoing basis to future personnel. Finally, all military installations will receive materials to help them organize their own financial education events and provide guidance for distributing investor education information. Public service announcements regarding the importance of saving and investing, on media outlets that serve military personnel in the United States and overseas, will supplement this effort.

Conclusion

NASD appreciates the diligence with which the GAO has researched and prepared its report. We are confident that the recommendations made to Congress and to financial regulators will help ensure that military personnel receive the level of protection they deserve as investors. NASD is committed to that goal and to providing them and all investors with the tools necessary to make informed investment decisions.

Sincerely,



Robert R. Glauber  
Chairman and Chief Executive Officer

# Comments from the National Association of Insurance Commissioners



NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

October 19, 2005

**EXECUTIVE  
HEADQUARTERS**

2301 MCGEE STREET  
SUITE 800  
KANSAS CITY MO  
64108-2662  
VOICE 816-842-3600  
FAX 816-783-8175

Mr. Richard Hillman  
Managing Director  
Financial Markets and Community Investment  
U.S. Government Accountability Office  
Room 2A28  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Hillman:

**GOVERNMENT  
RELATIONS**

HALL OF THE STATES  
444 NORTH CAPITOL ST NW  
SUITE 701  
WASHINGTON DC  
20001-1509  
VOICE 202-624-7790  
FAX 202-624-8579

Thank you for the opportunity to comment on the proposed report titled "Financial Product Sales: Actions Needed to Better Protect Military Members." State insurance regulators believe military personnel should be afforded the highest level of consumer protection when purchasing insurance. To this end, the NAIC would like to address the matters for congressional consideration and recommendations.

**SECURITIES  
VALUATION  
OFFICE**

48 WALL STREET  
6<sup>TH</sup> FLOOR  
NEW YORK NY  
10005-2906  
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FAX 212-382-4207

The first matter for congressional consideration directs states to review currently approved products that are being marketed primarily to military members to ensure that all such product provisions are in compliance with existing state laws. As the GAO report points, thousands of junior military personnel have purchased a product that combines life insurance with a savings fund promising high returns. In recognition of this issue, the NAIC's Life Insurance & Annuities (A) Committee has established the following proposed charge for 2006:

Review life insurance sold with a side fund to recommend a position on the products being offered in the marketplace.

**WORLD  
WIDE WEB**

[www.naic.org](http://www.naic.org)

In addition, a number of states are actively examining the small number of companies that have engaged in questionable marketing practices involving these products.

Another matter for congressional consideration is for state insurance regulators to have full access to persons and information necessary to oversee the sales taking place on military installations. State insurance departments can take corrective action sooner rather than later if timely and complete information is available for review. Coupled with this consideration is the congressional consideration that the U.S. Department of Defense (DoD) and insurance regulators work cooperatively to develop mechanisms to share information

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**Appendix VIII**  
**Comments from the National Association of**  
**Insurance Commissioners**

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Mr. Richard Hillman  
Page 2 of 2  
October 19, 2005

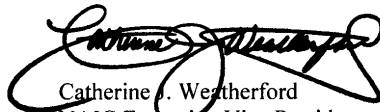
about insurance activities. Since becoming aware of the sales issues to military personnel, state insurance regulators have reached out to the DoD. Diane Koken, the NAIC President, has made two personal visits with the DoD and continues to foster a relationship of ongoing cooperation with the DoD. More specifically, the NAIC is in the process of accomplishing the following: (1) compiling a list of insurance department contacts for the DoD to ensure the DoD has the proper contact information for further state assistance; (2) updating the NAIC's Complaint Database System (CDS) 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 also notices that the final recommendation of the report is for the DoD and state insurance regulators to work cooperatively to develop financial management training materials for military personnel. To this end, the NAIC, in conjunction with the DoD, developed a consumer brochure specifically addressing life insurance information for military personnel. The NAIC also developed the following Web link for military personnel: [http://www.naic.org/consumer\\_military\\_insurance.htm](http://www.naic.org/consumer_military_insurance.htm) and is working with the DoD to update this Web link, as needed. Not only does this Web link contain information on life insurance, this Web link also contains information about other lines of insurance and how to electronically file a complaint with a state insurance department. Moving forward, the NAIC remains committed to working with the DoD to develop other insurance consumer brochures, which the DoD believes are necessary to fill any financial literacy needs of military personnel.

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.

Again, we appreciate the opportunity to comment on the draft report and provide an update on the activities of state insurance regulators. Please do not hesitate to contact us if we can be of further assistance.

Sincerely,



Catherine J. Weatherford  
NAIC Executive Vice President and Chief Executive Officer

Attachment

# GAO Contact and Staff Acknowledgments

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## GAO Contact

Richard J. Hillman (202) 512-8678

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## Staff Acknowledgments

In addition to the individual above, Cody Goebel, Assistant Director; Joseph Applebaum; Gwenetta Blackwell-Greer; Tania Calhoun; Rudy Chatlos; Lawrence Cluff; Barry Kirby; Marc Molino; Josephine Perez; David Pittman; and Amber Yancey-Carroll made key contributions to this report.

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