

**GAO**

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

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# FINANCIAL PRODUCT SALES

## Actions Needed to Protect Military Members

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Highlights of [GAO-06-245T](#), testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

## Why GAO Did This Study

In 2004, a series of media articles alleged that financial firms were marketing expensive and potentially unnecessary insurance or other financial products to members of the military. GAO's report for this committee examined (1) features and marketing of certain insurance and securities products being sold to military members and (2) how financial regulators and the Department of Defense (DOD) were overseeing the sales of insurance and securities products to military members. GAO also examined issues relating to DOD's oversight of insurance sales for a report issued in June 2005.

## What GAO Recommends

GAO's report to this committee recommends that Congress consider acting to ban contractual plans, have regulators ensure that products being sold to military members meet existing insurance requirements, and have appropriateness or suitability standards for military sales developed. GAO's report also recommends that DOD and financial regulators take steps to improve information sharing between them and take other steps to improve their oversight efforts. These organizations provided comments generally agreeing with this report and its recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-06-245T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-245T).

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

# FINANCIAL PRODUCT SALES

## Actions Needed to Protect Military Members

### What GAO Found

A limited number of firms accused of using deceptive sales practices are targeting costly financial products to military members with features that reduce their benefits to military purchasers. Although some service members benefited from a product that combines insurance with a savings component, the additional coverage was more expensive than the low-cost government insurance almost all service members already receive. One feature reducing these products' benefits was that if the service member ever stopped making payments and did not request a refund, the accumulated savings is used to continue the life insurance coverage. With military members often leaving the service within a few years, most stopped their payments and likely failed to amass any savings from their purchase. Various regulatory and other actions have been taken against the insurance companies that sell these products in the past and new investigations are underway in 14 states over whether these companies have failed to clearly identify the products as insurance as required by law or whether the products' features comply with all state insurance requirements. A small number of broker-dealers were also marketing a securities product—the mutual fund contractual plan—that has largely disappeared from the civilian marketplace. Although potentially providing returns equivalent to other products if steady payments are made over a long period, these contractual plans proved more expensive to most military purchasers than other widely available alternative products because many military members stopped making payments in the first few years. In addition, the largest broker-dealer selling contractual plans has already been sanctioned by regulators for using misleading marketing materials and examinations into the practices of other firms marketing this product are also underway.

A lack of routine complaint sharing by DOD prevented financial regulators from identifying inappropriate sales to military service members earlier. Although insurance regulators in some states review sales activities periodically, most rely on complaints to indicate that potentially problematic sales are occurring, particularly since no appropriateness or suitability standards exist for insurance. Securities regulators' efforts were also hampered by the lack of complaint sharing from DOD personnel. Because sharing with financial regulators can be complicated by privacy regulations and potential legal restrictions, DOD personnel at individual installations generally resolved matters involving product sales with companies directly. However, in light of the problems identified in our June 2005 report and the report issued for this committee, DOD has efforts underway to revise its solicitation policies regarding such sales, and has reviewed ways in which it can legally share additional information with financial regulators. However, DOD has not yet issued these new policies or coordinated with military installation personnel or with regulators on appropriate ways that additional sharing could occur.

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Mr. Chairman and Members of the Subcommittee:

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

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

In summary:

A limited number of firms accused of using deceptive sales practices are targeting costly financial products to military members with features that reduce their benefits to military purchasers. About six insurance companies are marketing products that combine high-cost insurance with a savings component. Although some service members and their survivors have benefited from these products, many have not. Most of the purchasers of these products were unmarried individuals with no dependents and thus may have had little need for more coverage beyond that already provided through the low-cost government insurance offered to service members. In addition, these products also appeared to be a poor

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<sup>1</sup>GAO-06-23 (Washington, D.C.: Nov. 2, 2005).

<sup>2</sup>See GAO-05-696 (Washington, D.C.: June 29, 2005).

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

A lack of routine complaint sharing between financial regulators and DOD was the primary reason that regulators did not generally identify the problematic sales of financial products to military service members until such accounts appeared in the media. Although insurance regulators in some states review sales activities periodically, insurance regulators in most states generally rely on complaints from purchasers to indicate that potentially problematic sales are occurring. One reason that insurance company sales activities are not reviewed more extensively is because most states lack any appropriateness or suitability standards for insurance

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

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products. Although conducting periodic examinations of broker-dealers sales practices, securities regulators' ability to identify problems involving the sale of contractual plans was also hampered by the lack of complaint sharing from DOD personnel and the absence of standardized information on the extent to which contractual plan purchasers were successfully making their payments. Because sharing with financial regulators can be complicated by privacy regulations and potential legal restrictions, DOD personnel at individual installations generally resolved matters involving product sales with the service member and the companies directly. However, in light of the problems identified in our June 2005 report and the report we issued for this committee, DOD has efforts underway to revise its solicitation policies regarding such sales and has reviewed ways in which it can legally share additional information with financial regulators. However, DOD has not yet issued these new policies or coordinated with its installation personnel or with regulators on appropriate ways that additional sharing can occur. State insurance and securities regulators also expressed concerns over whether their jurisdiction over sales of financial products on military installations was sufficiently clear.

Given the concerns over potentially inappropriate financial product sales to military members, the need for definitive actions to better protect service members appears overdue. The report we issued to this committee recommends actions by Congress that are consistent with many of the provisions that seek to improve protections for military members in the bills that passed the House of Representatives and are under consideration in the U.S. Senate.<sup>4</sup> Because the features of the products being sold to military members provided limited benefits to many military purchasers, we believe that Congress should act to have all state insurance regulators conduct reviews to ensure that only legal products are being sold to military members and to have regulators work cooperatively with DOD to develop standards that could help ensure that companies only market products appropriate for the military members' needs and circumstances. Similarly, given the wide availability of less expensive alternatives, Congress should act to amend the Investment Company Act to ban the sale of contractual plans. Because financial regulators' ability to adequately oversee sales to military members was hampered by a lack of information sharing about military members' complaints and concerns, we also

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<sup>4</sup>See Military Personnel Financial Services Protection Act, H.R. 458, 109th Congress (2005) and Military Personnel Financial Services Protection Act, S. 418, 109th Congress (2005).

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recommend that Congress direct DOD to work with insurance and securities regulators to overcome barriers to sharing information and to clarify that state regulators have jurisdiction on military installations. In the report prepared for this committee, we also recommend that DOD issue its revised solicitation policies that will require military personnel to share complaints with financial regulators. To improve oversight by state insurance regulators, SEC, and NASD, we recommend that these organizations designate specific members of their staff to receive complaints and conduct outreach to proactively learn of problems involving military members. In the event that contractual plans continue to be sold, we also recommended that SEC and NASD improve the information they have to assess the sales of contractual plans. DOD, SEC, NASD, and the National Association of Insurance Commissioners (NAIC) provided comments on our current report and indicated that they intend to take steps to consider and implement our recommendations.

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

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

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

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automatic premium payment deductions from military members' paychecks for these insurance products.

These products provide additional death benefits but are significantly more expensive than other life insurance coverage available to service members. For example, service members purchasing these products make payments of about \$100 per month for additional death benefits generally ranging from \$25,000 to \$50,000. In contrast, all service members are currently able to purchase \$400,000 of life insurance through Servicemembers' Group Life Insurance (SGLI) for \$26 per month.<sup>5</sup>

Although the insurance products these six companies were selling also included a savings component that recently promised to earn interest between 6.5 and 8.1 percent, these products also included features that reduced the likelihood that service members purchasing them would accumulate large amounts of savings. As we reported, military members move frequently and many leave the service after a few years, which may reduce their ability or willingness to continue making payments to fulfill a long-term financial commitment. However, the products being marketed by these insurance companies require a long series of payments to result in significant benefits to their purchasers. For example, most of the payments made in the earliest years—ranging from 1 to 7 years—would be used to pay the premiums for life insurance coverage. In subsequent years, more of the service members' payment would be allocated to the savings component.<sup>6</sup> In addition, these products also included features that allowed the companies to use the money accumulated in a service member's savings fund to automatically pay any unpaid insurance premiums. Although this would extend the period of

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

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

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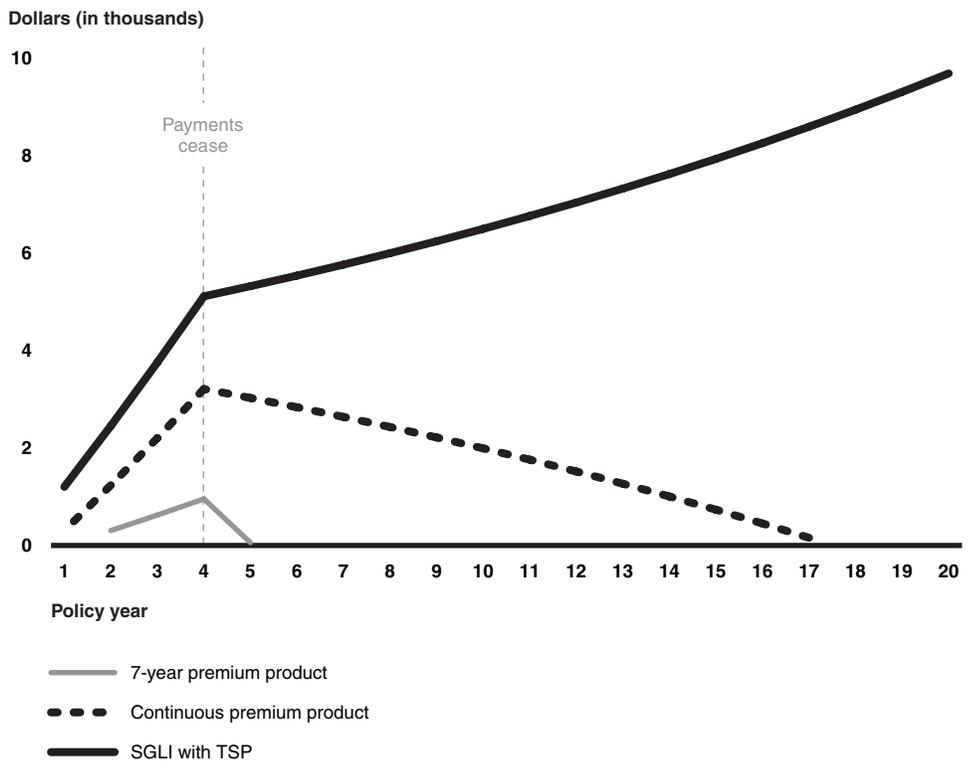
time that these service members would be covered under the insurance policy, data we obtained from several of these companies indicated that 40 percent or more of the service members that purchased these products stopped making payments within the first 3 years. With regulators indicating that most purchasers failed to request refunds of their saving fund balance, few likely accumulated any savings as a result of their purchase.

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

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<sup>7</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 Veterans' Group Life Insurance (VGLI) and can either leave any accumulated savings in TSP, withdraw the money from TSP, or roll over the TSP balance into a similar savings instrument, such as an individual retirement account. In addition, we used the low risk TSP G Fund for this calculation because it invests in interest bearing securities and thus was comparable to the interest earning products offered by these insurance companies.

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



Source: GAO analysis.

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

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

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

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

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

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<sup>8</sup>[GAO-05-696](#).

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

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

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

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<sup>9</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.

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

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

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

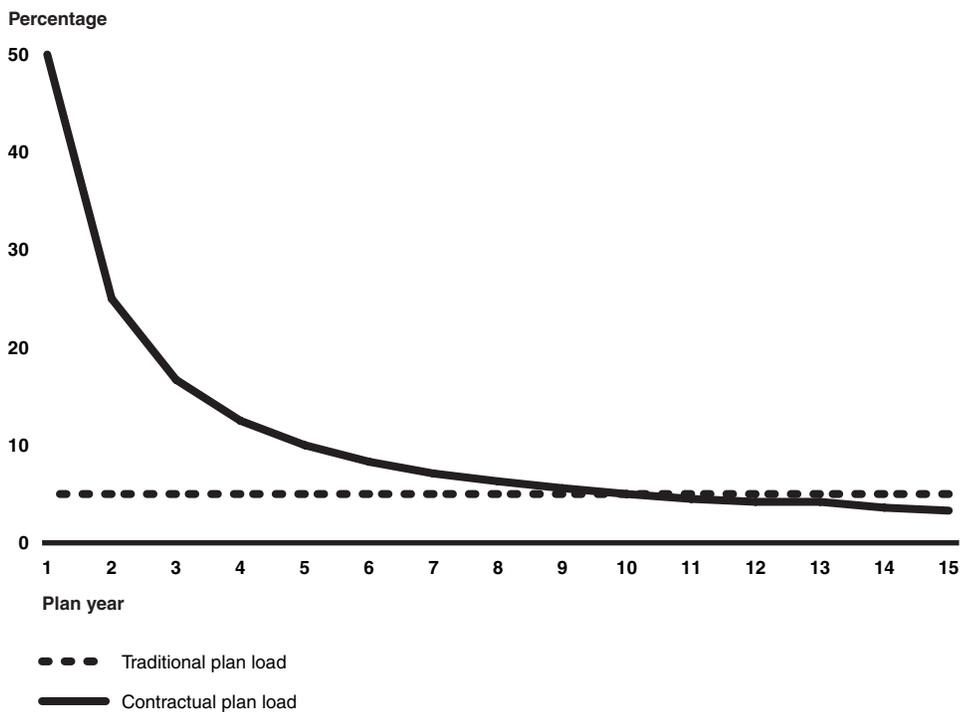
While sales charges for contractual plans are initially much higher than those of other mutual fund products, the effective sales load—the ratio of the total sales charge paid to the total amount invested—becomes lower as additional investments are made. Over time the effective sales load for a contractual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

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<sup>10</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.

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

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



Source: GAO analysis.

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

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of \$1,000 or less, with 9 having minimum investment amounts of \$250 or less.<sup>11</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 currently invest up to 10 percent of their gross pay into TSP without paying any sales charge. The various funds offered as part of TSP also have much lower operating expenses than other mutual funds, including those being offered as contractual plans. Service members could also choose to invest as many other investors do in mutual funds offered by companies that do not charge any sales load. Called no-load funds, these are available from some of the largest mutual fund companies over the telephone, the Internet, or by mail.

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

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

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<sup>11</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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concerns involving contractual plans during the 1950s and 1960s also led Congress to amend the Act in 1970 to further limit the maximum sales charges and to provide a period in which purchasers could obtain refunds of their investment. Firms marketing contractual plans have again been accused of inappropriate sales practices. In December 2004, SEC and NASD sanctioned the largest broker-dealer marketing these plans to service members after alleging that the firm's marketing materials were misleading. For example, according to the regulators, the firm's marketing materials allegedly included various misleading comparisons of contractual plans to other mutual funds, including characterizing non-contractual funds as attracting only speculators, and erroneously stating that withdrawals by investors in other funds force the managers of those funds to sell stocks. The regulators also alleged that the firm's materials did not present the low-cost TSP as a viable alternative to their contractual plans. This firm agreed to pay a total of about \$12 million and has voluntarily discontinued sales of contractual plan products. About \$8 million of the total money paid by this firm is to be used to fund financial education efforts for military members that are being developed and administered by NASD. Regulatory examinations of the other four smaller broker-dealers that continue to sell contractual plans are continuing.

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

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<sup>12</sup>S. 418, Sec. 3, and H.R. 458, Sec. 102.

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

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

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

To reduce the likelihood that service members will be marketed products inappropriate to their needs, in the report we prepared for this committee, we recommend that Congress act to have insurance regulators work

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<sup>13</sup>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.

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cooperatively with DOD to develop suitability or appropriateness standards that would apply to the sale of financial products to military members. The bills being considered in the U.S. Senate include provisions to have these parties work together to develop such standards.<sup>14</sup> Such standards could ensure that companies offer only products that address actual service member needs for insurance and that take into account service members' itinerant lifestyles and income levels. Having such standards could also provide protection for service members that are located in overseas installations not directly overseen by state regulators.

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

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

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<sup>14</sup>S. 418, Sec. 9, and H.R. 458, Sec. 108.

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better information on the extent to which broker-dealer customers are successfully making their payments.

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

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

Although DOD personnel had not routinely shared service member complaints with financial regulators in the past, DOD officials have told us that they intend to require their personnel to report more of this type of information to regulators. Under the current solicitation policy directive, DOD personnel are not required to share information relating to service member concerns or complaints with other parties, and the revised draft

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<sup>15</sup>DOD Directive 1344.7, *Personal Commercial Solicitation on DOD Installations* (Feb. 13, 1986).

<sup>16</sup>S. 418, Sec. 11, and H.R. 458, Sec. 110.

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that was published for comment also lacked any provisions relating to such information. In addition, when we issued our June 2005 report on DOD's insurance solicitation oversight, DOD was reluctant to provide information to regulators beyond indicating that DOD installations had suspended or revoked a given firm's or individual's solicitation privileges or that the violations involved the eligibility of the agent to hold a State license or meet other regulatory requirements.<sup>17</sup> However, staff in the office that oversees the policy directive told us more recently that they intend to specifically require in the new directive that base personnel report to financial regulators any service member concerns or complaints that relate to the quality of the financial products offered to them or regarding the appropriateness of the practices used to market these products. DOD has not, as of yet, issued this new directive. To ensure that financial regulators have critical information that they need to identify problematic products and sales practices, the report we prepared for this committee recommends that DOD issue a revised DOD solicitation policy directive that would require that information on service member complaints related to financial product sales be provided to relevant state and federal financial regulators.

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

However, DOD has not acted to fully address potential barriers to increased sharing with financial regulators. For example, securities regulatory staff told us that while they were conducting their investigations of contractual plan sales, personnel at some DOD installations were reluctant to share any information involving specific service members for various reasons. According to these regulators, the

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

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installation personnel cited military privacy regulations and the restrictions that arise from attorney-client privilege if the service member was being assisted by military legal counsel. According to the director of the DOD office responsible for administering the solicitation policy, such issues can affect their ability to share information with entities outside the military. However, he explained that DOD has researched these legal issues and now believe that they can share information that is deemed to be necessary for the official needs of the requesting organization, including financial regulators. This DOD official also acknowledged that more coordination could be done to ensure that both military installation personnel and financial regulatory staff understand how additional sharing could appropriately occur

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

Another concern over whether military members are adequately protected from inappropriate sales stems from uncertainty over financial regulators' jurisdiction on U.S. military installations. Although most of the insurance and securities regulators we contacted believed they had jurisdiction over the sales of financial products on military installations, some regulators expressed uncertainty over their authority to regulate sales on military installations, where the federal government may have "legislative jurisdiction."<sup>18</sup> For example, a Texas insurance department official told us that he had trouble getting access to complaints information at a military installation because installation personnel questioned his authority to

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<sup>18</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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request such information. As part of the work on DOD's oversight of insurance sales that we reported on in June 2005, we surveyed the various state and territorial insurance commissioners.<sup>19</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. 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.

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

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

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## GAO Contacts and Acknowledgements

For further information regarding this testimony, please contact Richard J. Hillman (202) 512-8678. In addition, others making key contributions to

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<sup>19</sup>GAO 05-696.

<sup>20</sup>S. 418, Sec. 6(a), and H.R. 458, Sec. 105(a).

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this statement included Cody Goebel, Assistant Director; Jack Edwards, Gwenetta Blackwell-Greer; Tania Calhoun; Barry Kirby; and Josephine Perez.

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

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

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

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

The absence of accurate data on the extent to which service members are purchasing supplemental life insurance limits the ability of DOD policy officials and installation solicitation coordinators to oversee such sales

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<sup>1</sup>GAO 05-696.

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

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and ensure that all relevant DOD policies are being followed. For example, the lack of accurate data prevents DOD personnel from readily identifying whether service members at a particular installation have submitted an unusually large number of new allotments for supplemental life insurance during a short period, which could indicate that a mass solicitation to recruits or trainees has occurred in violation of DOD's personal commercial solicitation policy directive.<sup>3</sup>

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

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

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<sup>3</sup>DOD Directive 1344.7.

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

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counseling is required or optional during the cooling-off period. In addition, the directive and the standard allotment forms do not contain procedures for documenting whether the counseling took place.

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

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

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

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To ensure that allotments are properly authorized, our June 2005 report recommended that DOD issue a message to all finance offices and DFAS offices that process allotments for supplemental life insurance to remind personnel that DOD's Financial Management Regulation indicates that only service members or their designated representatives with special power of attorney for the prescribed purpose are authorized to start, stop, or modify financial allotments. In its comments on a draft of our report, DOD concurred with this recommendation and stated that it will issue such a statement.

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