

**Report on Refunds, Sales Practices, and Revenues from
Periodic Payment Plans**

**As Required by
Section 4(c) of the
Military Personnel Financial Services Protection Act**

U.S. Securities and Exchange Commission



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I. EXECUTIVE SUMMARY

On September 29, 2006, Congress enacted the Military Personnel Financial Services Protection Act of 2006 (“Act”)¹ to protect members of the Armed Forces from unscrupulous practices regarding sales of insurance, financial, and investment products. Among other things, the Act prohibited the issuance and sale of new periodic payment plan certificates after October 29, 2006, without invalidating any rights or obligations under a certificate sold before that date. It also required the Securities and Exchange Commission (“Commission”) to prepare a report on various matters relating to broker-dealers and the sale of periodic payment plans over the five-year period preceding submission of the report, from 2002 to 2006 (the “report period”). This report is submitted in compliance with the Act.

As background, periodic payment plans are a type of investment company, organized as unit investment trusts and registered with the Commission. The plans allow investors to accumulate shares of mutual funds indirectly by contributing fixed monthly payments, usually by making 180 small monthly payments over a period of at least 15 years. They are subject to a sales charge or “load” that is unique to this product: 50% of the plan’s first 12 monthly payments. As a result of this charge, the effective sales load paid by an investor is highly dependent on the number of payments made. Generally, if an investor ceases making payments earlier than the 120th payment, that is, on or about the tenth anniversary of establishing the plan, a higher sales charge is paid than would have been paid if the investor had simply bought a conventional open-end equity mutual fund with an average sales load.

These plans had significant market share around 1970, with approximately 13% of open-end equity fund assets. By January 2006, the popularity of these plans had diminished significantly, and these products held only approximately two tenths of one percent of all assets in open-end equity funds. Moreover, growth in the assets collected by these plans was flat over the report period, while open-end equity funds experienced growth of approximately 44%.

Periodic payment plans are managed and sponsored by investment company complexes. The number of plan sponsors of periodic payment plans has also declined since 1970. In that year approximately 80 sponsors offered periodic payment plans. By 2002, the beginning of the report period, only nine sponsors were in operation, with two of them holding 75% of plan assets. Moreover, of the nine sponsors in operation, only four continued to offer plans to investors in 2002, and three of those closed their plans during the report period. As a result, by the time the Act went into effect, only one sponsor’s plan remained open to new investors.

¹ Military Personnel Financial Services Protection Act, 109th Cong., 2d Sess., Pub. L. No. 109-290, 120 Stat. 1317 (September 29, 2006) (prefatory material).

Periodic payment plans were sold to retail investors by broker-dealers. Sponsors identified 127 broker-dealers that sold periodic payment plans during the report period, representing approximately 2.4% of all registered broker-dealers at the time the Act went into effect.

The Act directed the Commission to report on several specific matters. These are summarized below, and detailed in this Report.

Revenues obtained by broker-dealers: Congress directed the Commission to describe the revenues obtained by broker-dealers from the sale of periodic payment plans during the report period. The Commission's staff ("Staff") determined that broker-dealers selling periodic payment plans during the report period generated approximately \$191,880,832 in revenue. Of this amount, \$159,103,583 constituted sales charges and \$32,777,249 constituted 12b-1 fees.² On a year-by-year basis, the bulk of this revenue was generated by broker-dealers during the early years of the report period, with a sharp decline in 2005 and 2006. The Staff also determined that nine dominant firms obtained revenues of \$186,546,572 during the report period, giving them approximately 98% of the total revenues generated by broker-dealers in the sale of periodic payment plans. Nonetheless, this revenue represented only 1% of the dominant firms' aggregate total revenue. Finally, because several plans closed to new investors during the report period, a substantial portion of the revenue paid to broker-dealers was paid by sponsors whose plans had already closed by the time the Act went into effect.

"Replacement" products: Congress directed the Commission to describe any products marketed by broker-dealers to replace the revenue generated from the sales of periodic payment plan certificates prohibited by the Act. The dominant broker-dealers have indicated that they are not marketing any products to replace periodic payment plans. The Staff tested and analyzed these assertions and found no evidence inconsistent with the dominant firms' claims.

Existence of voluntary refunds: Congress directed the Commission to describe any measures taken by a broker-dealer to voluntarily refund payments made by military service members on any periodic payment plan certificate, and the amounts of such refunds. Of the dominant broker-dealers only one indicated that it is offering refunds to military service members: First Command Financial Planning, Inc. ("First Command")³ It is doing so pursuant to an enforcement action that predated enactment of the Act. Pursuant to the restitution plan established in that action, First Command has issued 10,845 restitution checks to investors with a total value of \$4,523,324.

² Rule 12b-1 under the Investment Company Act of 1940, permits funds to make payments for distribution expenses so long as certain conditions are met. *See* Distribution of Shares by Registered Open-End Management Investment Companies, 17 C.F.R. 270.12b-1, as last amended in Release No. IC-26591, 69 F.R. 54728 (2004). Asset-based fees charged to a fund for this purpose are generally called "12b-1 fees."

³ *First Command Financial Planning, Inc.*, Release No. 8513, 84 S.E.C. 1332 (December 15, 2004).

Sales practices to military personnel: Congress directed the Commission to describe the sales practices of broker-dealers on military installations over the report period. To fulfill this mandate, the Commission addressed a broader question: what are the sales practices of broker-dealers in connection with sales of securities to military personnel? This approach captures sales activity both on the premises of military installations and in sales offices located off-base, but near military bases. The Staff observed that many sales of securities to military personnel take place off-base, often in sales offices immediately outside the gates of military installations. Taking this approach, the Staff observed several problems in the sale of securities to military personnel. These included: misstatements regarding periodic payment plans; misstatements regarding the wealth-building potential of certain other securities products; the marketing of periodic payment plans to low-ranking personnel who may not be able to maintain the payments; and other concerns such as supervision of sales agents, especially in sales offices located outside bases overseas, and recommendations of sales agents to current holders of periodic payment plans. In its oversight of broker-dealers, the National Association of Securities Dealers (“NASD”), a self-regulatory organization (“SRO”) for broker-dealers, has found similar problems.

Any recommendations: Finally, Congress directed the Commission, after such consultation with the Secretary of Defense as the Commission considers appropriate, to describe any legislative or regulatory recommendations to improve sales practices on military installations. Several legislative and regulatory initiatives have already been adopted, including the prohibition on sales of periodic payment plans; the on-going initiatives by the Department of Defense; the continuing oversight by the Commission and the NASD of broker-dealers that sell securities to military personnel; and the Commission and NASD’s active program of investor education for uniformed military personnel. In light of these active initiatives, which have already achieved considerable success, the Commission has no further legislative or regulatory recommendations to make at this time.

II. INTRODUCTION

Section 4(c) of the Act requires the Commission to prepare a *Report on Refunds, Sales Practices, and Revenues from Periodic Payment Plans* (“Report”). This provision further requires the Commission to submit the Report to the Committee on Financial Services of the U.S. House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate not later than six months after the date of enactment of the Act. This Report is submitted to the Committee on Financial Services of the U.S. House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate in compliance with the Act.

A. The Military Personnel Financial Services Protection Act of 2006

Congress enacted the Act to protect members of the Armed Forces from unscrupulous practices regarding sales of insurance, financial, and investment products. In Section 2 of the Act, Congress found that members of the Armed Forces perform great sacrifices in

protecting our Nation, and that they deserve to be offered “first rate financial products in order to provide for their families and to save and invest for retirement.”⁴ Unfortunately, as Congress also found, members of the Armed Forces were not always receiving such products. Instead, they were being offered high-cost securities and life insurance products by some financial services companies engaging in abusive and misleading sales practices.⁵ Congress made findings about two specific products in this regard.

First, Congress found that one securities product offered to service members, known as the “mutual fund contractual plan,” had largely disappeared from the civilian market during the 1980s, “due to excessive sales charges.”⁶ In such a plan, a 50% sales commission is assessed against the first year of contributions, despite an average commission on other securities products of less than 6% on each sale. The plans’ “excessive sales charges” allow abusive and misleading sales practices.⁷

Second, Congress found that certain life insurance products being offered to members of the Armed Forces are improperly marketed as investment products, providing minimal death benefits in exchange for excessive premiums that are front-loaded in the first few years.⁸ These products, Congress found, are “entirely inappropriate for most military personnel.”⁹

Congress concluded its findings by stating that “the need for regulation of the marketing and sale of securities and life insurance products on military bases necessitates Congressional action.”¹⁰ Most importantly, for purposes of this Report, Congress prohibited periodic payment plans. Section 4(a)(1) of the Act states that effective 30 days after the date of enactment, it shall be unlawful for any registered investment company to issue any periodic payment plan certificate, or for any such company, or any depositor of underwriter for such a company, or any other person to sell such a certificate.¹¹ Section 4(a)(2) provides that this provision shall not “alter, invalidate, or otherwise affect any rights or obligations, including rights of redemption,” under any

⁴ *Supra.* at note 1, §2.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* Mutual fund contractual plans are also known as “periodic payment plans” or “periodic payment plan certificates.”

⁸ *Id.* at §2.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at §4(a)(1).

periodic payment plan sold before the termination date.¹² As a result, while existing plans remain in effect, no new plans may be issued or sold after October 29, 2006.

In Section 4(c) of the Act, Congress required the Commission to prepare a report¹³ that shall describe:

(1) any measures taken by a broker or dealer registered with the Securities and Exchange Commission pursuant to section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)) to voluntarily refund payments made by military service members on any periodic payment plan certificate, and the amounts of such refunds;

(2) after such consultation with the Secretary of Defense, as the Commission considers appropriate, the sales practices of such brokers or dealers on military installations over the 5 years preceding the date of submission of the report and any legislative or regulatory recommendations to improve such practices; and

(3) the revenues generated by such brokers or dealers in the sales of periodic payment plan certificates over the 5 years preceding the date of submission of the report, and the products marketed by such brokers or dealers to replace the revenue generated from the sales of periodic payment plan certificates prohibited under subsection (a).

This Report has been prepared in conformity with the requirements of Section 4(c), as set forth above. The order of presentation has been slightly modified from the order of Section 4(c) of the Act. The discussion of possible legislative or regulatory recommendations is last.

B. Methodology of this Report

To prepare this Report, the Staff used various means to collect information relevant to the Congressional mandate for the five year review period. The Staff gathered information on periodic payment plans from the Commission's own public, examination, and enforcement files.

The Staff also utilized the Commission's examination authority to collect information from the nine investment company complexes that sponsored periodic payment plans during the report period. These sponsors issued 100% of the registered periodic payment plans that were in operation during the report period. The Staff also used the Commission's examination authority to collect information from nine broker-dealers that earned significant revenues from sales of period payment plans during the report period. These firms earned approximately 98% of the revenue that broker-dealers obtained from sales of periodic payment plans during the report period. They are described herein as

¹² *Id.* at §4(a)(2).

¹³ *Id.* at §4(c).

the “dominant” broker-dealers because they dominated the market for periodic payment plans. The Staff also collected information from SROs for broker-dealers, and consulted with the Department of Defense.

III. BACKGROUND

Periodic payment plans were issued and sold for many decades prior to the prohibition on such activities in Section 4(a) of the Act. Three types of institutions played crucial roles in this activity. They were: the periodic payment plans themselves; the sponsors that organized and brought the plans to market; and the broker-dealers that sold the plans to investors, including military personnel. Each type of institution is discussed below.

A. Periodic Payment Plans

Periodic payment plans involve the offer and sale of mutual fund investments by plan sponsors through an installment method known as a “contractual” or “systematic investment plan.” They are defined in Section 2(a)(27) and regulated under Section 27 of the Investment Company Act of 1940. Section 2(a)(27) of the Investment Company Act defines a periodic payment plan generally as a security in which an investor makes a series of periodic payments to acquire an undivided interest in certain specified securities or in a unit or fund of securities. Among other things, Section 27 of the Investment Company Act limits the sales charges that periodic payment plans may impose.¹⁴

Periodic payment plans are registered investment companies generally, organized as unit investment trusts under Section 26 of the Investment Company Act of 1940. As investment companies they are required to file a registration statement with the Commission¹⁵ and provide investors with a prospectus.¹⁶ Thereafter, they are required to file with the Commission annual reports on Form N-SAR.¹⁷ Investors purchase an interest in the unit investment trust. By acquiring an interest in the trust, investors are able to accumulate shares of mutual funds indirectly by contributing to the trust or custodian a fixed investment amount on a regular basis. The trusts, in turn, invest the proceeds in open-end equity mutual funds. Investments in the underlying mutual funds are net of trust and custodial fees and a *pro rata* share of the fees and commissions

¹⁴ Investment Company Act of 1940 § 27(a), 15 U.S.C. § 80a-27 provides for alternative limitations on sales charges.

¹⁵ The statement must be filed within three months after the filing of notification of registration under Section 8(a), 15 U.S.C. § 80a-8. *See also*, 17 C.F.R. 270.8b-5 (1954).

¹⁶ *See* Section 10(a) of the Securities Act of 1933, 15 U.S.C. § 77j.

¹⁷ *See* 17 C.F.R. 274.101. Both the designation N-SAR or N-SAR-U represent the reporting form used for semi-annual and annual reports by all investment companies that have filed a registration statement, which is effective under the Securities Act of 1933. Registered management investment companies are required to file a Form N-SAR under 17 C.F.R. 270.30b1-1 as last amended in Release No. 34-47262, 68 F.R. 5348 (2003) and registered unit investment trusts are required to file a Form N-SAR-U under 17 C.F.R. 270.30a-1 as last amended in Release No. 34-47262, 68 F.R. 5348 (2003).

associated with the underlying mutual funds.¹⁸ The installment contracts usually contemplate 180 payments ranging from \$100 to \$500, over a period of at least 15 years. As a result, when entering into a periodic payment plan, an investor makes a long-term financial commitment.

Periodic payment plans are usually subject to a sales charge unique to this type of investment, referred to as a “sales and creation charge” or “front-end load” that equals 50% of the plan’s first 12 monthly payments. There is no sales charge after the first 12 payments. As a result of this unique sales charge, the amount of the effective sales charge paid by an investor is directly dependent on the number of payments made.¹⁹

Once an investor has completed the first 12 payments, the effective sales load is reduced with each payment. For example, if the investor makes all 180 payments under the plan, the effective sales load on the total investment would be 3.33%.²⁰ If 300 payments are made, then the effective sales load on the total investment would be 2%. Conversely, if the investor ceases making payments or terminates the plan before making all of the required payments under the plan, the effective total sales load may be higher than the average sales load charged by a conventional open-end equity mutual fund. The effective sales load on the total investment at various discontinuation points is illustrated below in *Table 1: Periodic Payment Plan Effective Sales Loads as of Number of Payments Made*.²¹

¹⁸ See *supra*, *First Command Financial Planning, Inc.* at note 3, generally discussing operations of periodic payment plans.

¹⁹ *Id.* at p. 2.

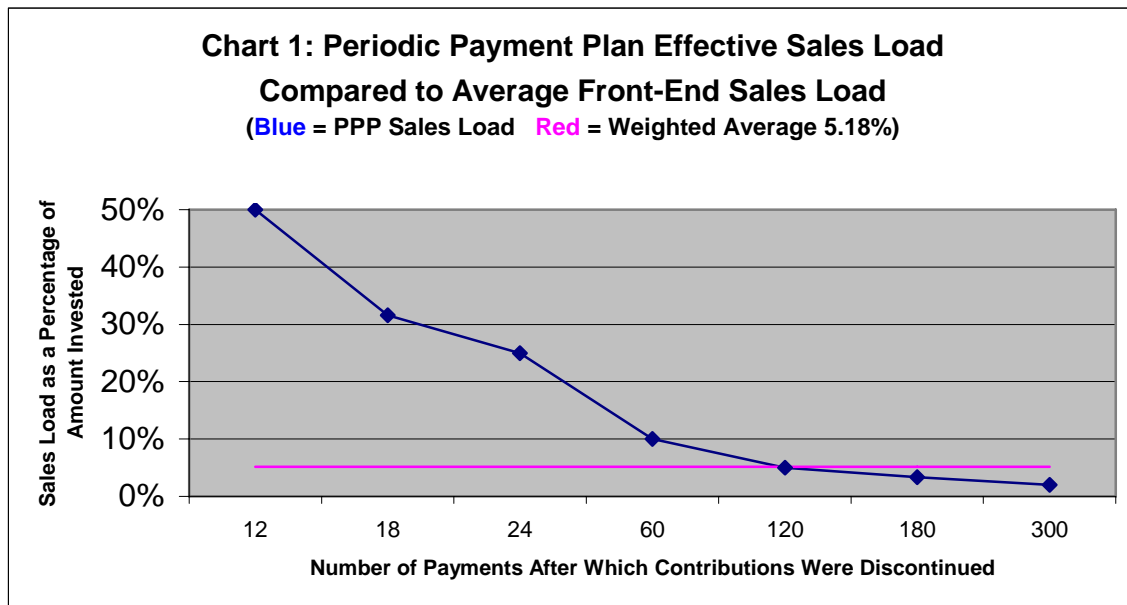
²⁰ The NASD informs us that according to the prospectuses, in certain plans, and for a specific share class, the sales charges and custodian fees may be up to 7.4%, even after completion of a fifteen year plan.

²¹ *Id.*, p.p. 3-4. The Staff converted the information into a table to illustrate the adverse effects on investors caused by prematurely terminating payments on a periodic payment plan.

Table 1: Periodic Payment Plan Effective Sales Loads Based on Number of Payments Made

Contributions Discontinued After:	Sales Load as a Percentage of Amount Invested:
12 payments	50.00%
18 payments	31.60%
24 payments	25.00%
60 payments	10.00%
120 payments	5.00%
180 payments	3.33%
300 payments	2.00%

The average front-end sales load on open-end equity mutual funds is 4.76%, with a weighted average of 5.18%.²² As a result, since 120 payments must be made to reach an effective commission of 5% on a periodic payment plan, it will generally take an investor approximately ten years to reach this point. The relationship between the effective sales charge on a periodic payment plan and the average front-end sales load is illustrated below in Chart 1: Periodic Payment Plan Effective Sales Loads Compared to Average Front-End Sales Load.²³

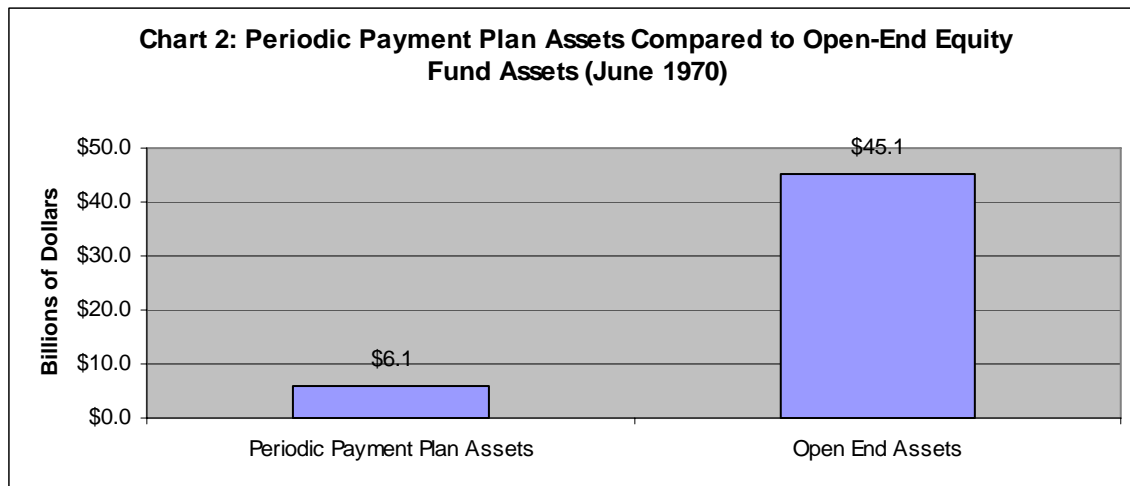


²² According to the *Lipper LANA database*, as of September 30, 2006, conventional open-end equity mutual funds charged approximately 4.76% as the average load and the weighted average was approximately 5.18%.

²³ See *supra*, Table 1.

In addressing how the effective sales charge relates to the number of payments, great care must be made to distinguish the “persistence rate” from the “completion rate.” While both terms relate to the length of time an investor has been in a plan, they are not the same. The persistence rate can include all accounts that remain in the plan, whether or not any payment has been made in the last year or more. In essence, the persistence rate can include all accounts that have not been terminated by the investor, including dormant or inactive plans for which payments ceased at a point producing an extremely high effective sales charge. The completion rate includes accounts that have actually made the contractually contemplated number of periodic payments. For example, in a recent enforcement action, the Staff was given data by a firm selling periodic payment plans that indicated an 80% “persistence rate.” However, the Commission determined that the completion rate on plans sold by this firm was only 43%.²⁴

Prior to the 1970s, periodic payment plans were one of the few ways by which small investors could make modest investments in mutual funds. As originally constituted, the mutual fund industry required investors to make relatively high initial investments. Periodic payment plans provided a means for small investors to make low-dollar investments in mutual funds. This gave them considerable popularity. In June 1970, for example, assets invested in periodic payment plans equaled more than \$6 billion, and investments in open-end funds equaled approximately \$45 billion. This is illustrated below in *Chart 2: Periodic Payment Plan Assets Compared to Open-End Equity Fund Assets (June 1970)*.²⁵



²⁴ See *supra*, *First Command Financial Planning, Inc.* at note 3.

²⁵ See *Classification, Assets and Location of Registered Investment Companies under the Investment Company Act of 1940, as of June 30, 1970* (SEC Publications and Forms NSAR-U) and the *2006 Investment Company Fact Book: 46th Edition* (Investment Company Institute).

While popular, periodic payment plans became associated with certain types of sales practice abuses. These concerns were addressed in provisions of the Investment Company Act of 1940 limiting the sales charges purchasers could be assessed when purchasing periodic payment plans.²⁶ Despite these limitations, during the 1950s and 1960s additional concerns were raised, including the sizes of sales charges and inappropriate sales practices. In the 1960s, the Staff studied mutual fund sales practices, including the sale of contractual plans. The Commission found that “[i]n the salesmen’s incentives of the contractual plan lie the greatest potential for unwarranted selling pressure on members of the public”²⁷ and recommended eliminating the front-end load and reducing fund sales charges to a maximum of 5%.²⁸

These efforts led to significant amendments to the Investment Company Act in 1970 to further limit maximum sales charges for periodic payment plans and to provide a period in which purchasers could obtain refunds of their investments.²⁹ The 1970 Act did not change Section 27(a) of the Investment Company Act, which continued to allow a deduction for sales charges equal to 50% of the first 12 monthly payments. However, new Subsections (d), (e) and (f) afforded holders of periodic payment plans certain specified rights of refund, withdrawal, and notice.³⁰

Beginning in the 1970s, alternative means were developed for making small investments in mutual funds. Firms began to allow investors to buy mutual fund shares directly and furnished services known as “automatic investment programs,” “asset builders” or “account builders.” These services allow investors to purchase shares on a regular basis, for example, by electronically transferring money from a designated bank account or paycheck. Most mutual funds do not charge a fee for setting up or terminating these automated transfer services. They applied to both load and no-load funds that accepted low initial investments and low periodic or automatic investment payment plans.³¹

Consequently, many investors started investing directly with an open-end mutual fund instead of with a periodic payment plan. In the years since, assets invested directly in open-end funds have outstripped periodic payment plans. For example, in January 2006,

²⁶ Section 27(a) of the Investment Company Act of 1940 capped the allowable sales load on the total payments to be made by the investor at 9% and the maximum portion of the first twelve monthly installment payments that may be deducted as sales load at 50%.

²⁷ Securities and Exchange Commission, Report of the Special Study of the Securities Markets at 99 (1963) (available at : [//www.sechistorical.org/collection/papers/1960/1963_SS_Sec_Markets/](http://www.sechistorical.org/collection/papers/1960/1963_SS_Sec_Markets/)).

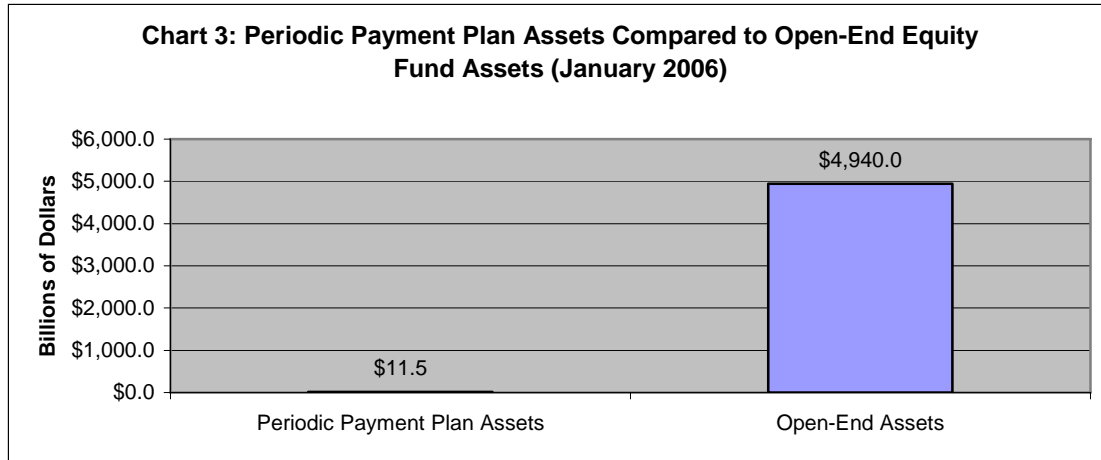
²⁸ Report of the U.S. Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth at 22 (Dec. 2, 1966)(available at: http://www.sechistorical.org/collection/papers/1960/1966_InvestCoGrowth/).

²⁹ Investment Company Amendments Act of 1970, Pub. L. 91-547, 84 Stat.1424, 1425 (1970).

³⁰Investment Company Act of 1940 § 27(d), (e), and (f), 15 U.S.C. § 80a-27 (d), (e), and (f).

³¹ See *supra*, *First Command Financial Planning, Inc.* at note 3.

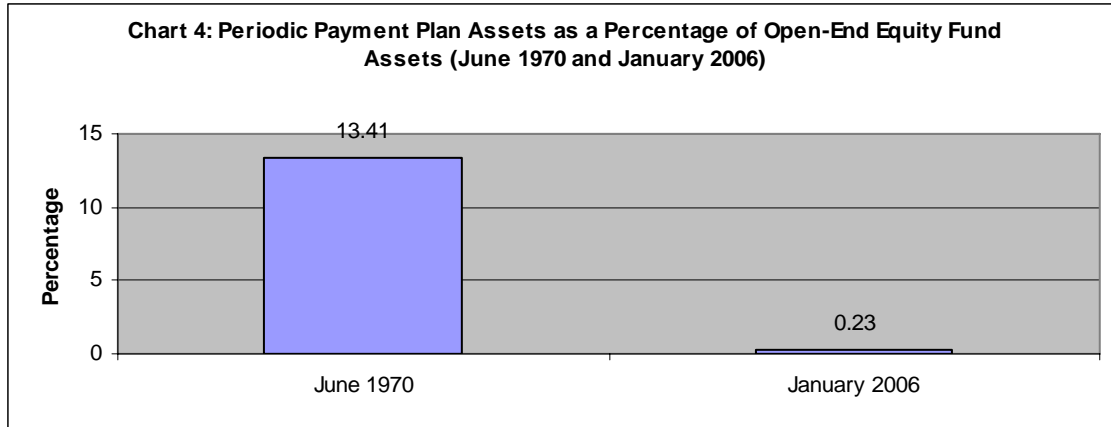
assets invested in open-end mutual funds had grown to \$4.9 trillion. At the same point in time, assets invested in periodic payment plans were only \$11.5 billion. This is illustrated below in *Chart 3: Periodic Payment Plan Assets Compared to Open-End Equity Fund Assets (January 2006)*.³²



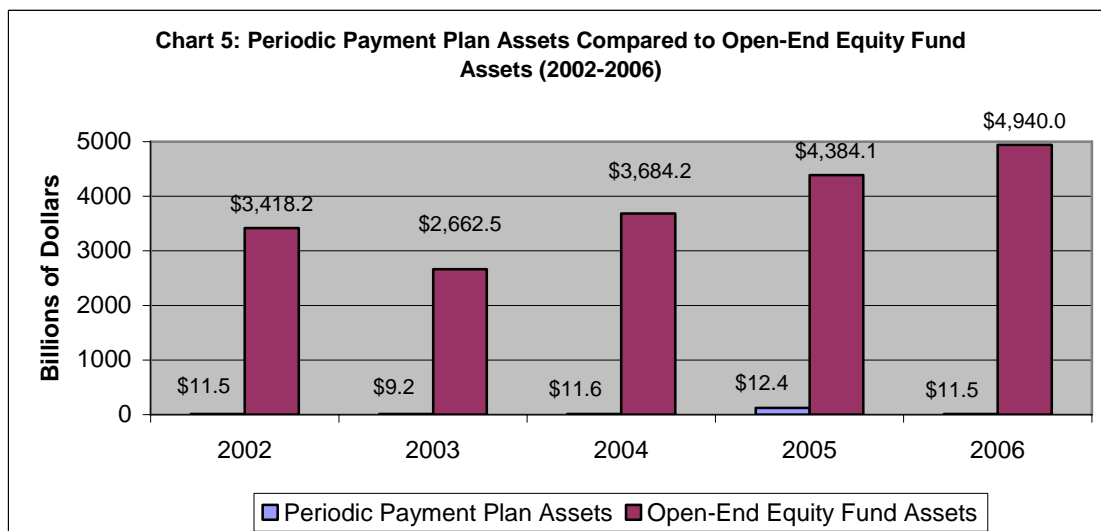
While assets invested in periodic payment plans have grown over the years since 1970, they have suffered a severe relative decline when compared to open-end mutual funds. Assets invested in periodic payment plans have grown from \$6.1 billion in 1970 to \$11.5 billion in January 2006. In other words, over a 35-year period invested assets have almost doubled. Yet, over the same period, assets invested in open end mutual funds have risen from \$45.1 billion to \$4,940 billion (or \$4.9 trillion), an increase of more than a hundred-fold. Given periodic payment plans' much slower growth rate, their assets have shrunk from more than 13% to less than a quarter of one percent (0.23%) of assets in mutual funds. This is illustrated below in *Chart 4: Periodic Payment Plan Assets as a Percentage of Open-End Equity Fund Assets (June 1970 and January 2006)*.³³

³² See generally *2006 Investment Company Fact Book: 46th Edition* (Investment Company Institute).

³³ See generally *2006 Investment Company Fact Book: 46th Edition* (Investment Company Institute); *Classification, Assets and Location of Registered Investment Companies under the Investment Company Act of 1940, as of June 30, 1970* (SEC Publications and Forms N-SAR) and 2006 N-SAR filings made with the Commission.

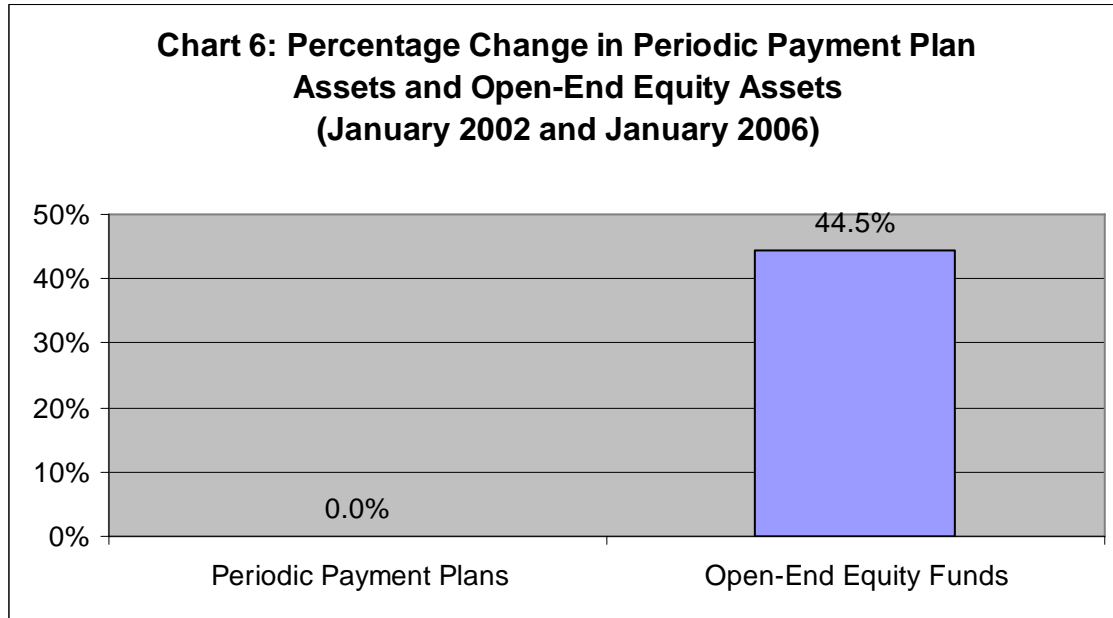


The relative decline in periodic payment plan assets does not appear to be attributable to general conditions in the securities markets. For example, during the report period, assets invested in periodic payment plans have remained flat. In 2002 they were \$11.5 billion, and in 2006 they were again \$11.5 billion. In 2003 they dipped to \$9.2 billion, probably as a result of the general market decline during that period. In 2004 and 2005 they rose again to \$11.6 and \$12.4 billion, respectively. Open-end equity fund assets also experienced a dip in the early 2000s. In 2002 they stood at \$3,418.2 billion, and they fell to \$2,662.5 billion in 2003. However, following the dip, while periodic payment plans only regained their prior levels of invested assets, open-end equity funds soared to \$3,684.2 billion in 2004, \$4,384.1 billion in 2005 and \$4,940 billion in 2006. The relative growth of periodic payment plans and open-end equity funds over the report period is illustrated below in *Chart 5: Periodic Payment Plan Assets Compared to Open-End Equity Fund Assets (2002-2006)*.³⁴



³⁴ 2006 Investment Company Fact Book: 46th Edition (Investment Company Institute) and N-SAR-U filings made with the Commission.

The aggregate relative growth of these two products over the report period provides a stark illustration of the decline in periodic payment plans. From 2002 to 2006 assets invested in open-end equity funds increased by 44.5%. At the same time, assets invested in periodic payment plans remained flat. This is illustrated below in *Chart 6: Percentage Change in Periodic Payment Plan Assets and Open-End Equity Fund Assets (January 2002 and January 2006)*.³⁵



By 2006 periodic payment plans were a small asset class that was experiencing flat growth. From a prominent position in 1970, they had shrunk to a tiny relative size when compared to open-end equity mutual fund assets. Even when general market conditions led to a rapid rise in mutual fund assets, such as the asset growth experienced by open-end equity funds in the years after 2003, assets invested in periodic payment plans remained flat.

B. Sponsors

A periodic payment plan sponsor organizes the plan, enters into agreements with service providers, such as a custodian for the plan assets, and then brings the plan to market by making arrangements for its distribution to investors. Sponsors are generally registered as broker-dealers, and are part of a larger investment company complex.³⁶ In June of 1970, approximately 80 firms sponsored periodic payment plans. By the time of the report period only nine sponsors were in operation, either offering plans that were open to

³⁵ *Id.*

³⁶ See Section III.C of this Report for a discussion of broker-dealers.

new investors or servicing existing periodic payment plans that were closed to new investors.

The nine sponsors of periodic payment plans in operation during the report period were: AIM Distributors; Baxter Financial Corp.; Capstone Asset Management; First Investors; FMR Corp.; Franklin/Templeton Distributors; Oppenheimer Funds Distributor; Pioneer Investment Management; and Washington Investor Plans Inc. As of October 2005, they sponsored a total of 19 plans. All nine sponsors are registered with the Commission as broker-dealers, and have affiliated investment advisory functions that are also registered with the Commission. Of those nine sponsors, only four sold the product at some point during the report period. These were: AIM Distributors; FMR Corp.; Franklin/Templeton Distributors; and Pioneer Funds Distributor. These sponsors distributed the periodic payment plans through five separate offerings.

As previously noted, periodic payment plans collectively held assets of approximately \$11.5 billion at the close of the report period. However, distribution of these assets among sponsors was highly concentrated. This can be seen below in *Table 2: Periodic Payment Plan Assets by Sponsors (2005)*.³⁷

Table 2: Periodic Payment Plan Assets by Sponsor (2005) In Millions

<u>Sponsor</u>	<u>Plan Assets</u>
AIM Distributors	\$ 2,342.1
Baxter Financial Corp.	\$ 47.3
Capstone Asset Management	\$ 6.8
First Investors	\$ 222.6
FMR Corp.	\$ 8,265.9
Franklin/Templeton Distributors	\$ 146.9
Oppenheimer Funds Distributor	\$ 49.5
Pioneer Investment Management	\$ 390.0
Washington Investor Plans Inc.	\$ 0.0 ³⁸

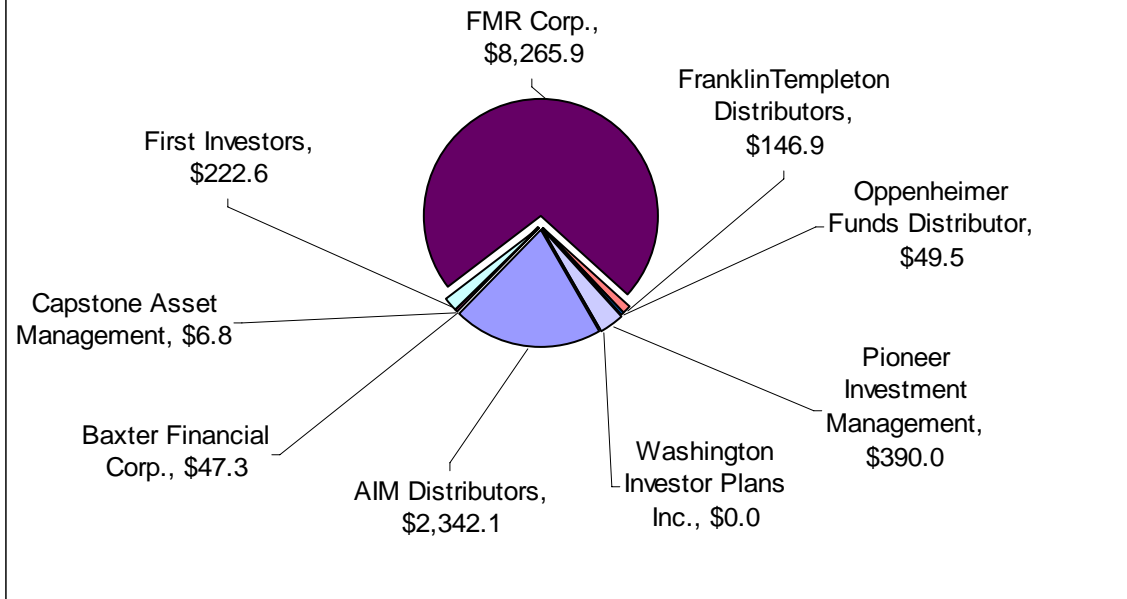
AIM Distributors and FMR, Corp., held the preponderance of assets, with 75% of the total. The relative size of the different sponsors is illustrated below in *Chart 7: Periodic Payment Plan Assets by Sponsor (2005)*.³⁹

³⁷ N-SAR Forms filed with the Commission.

³⁸ Washington Investor Plans, Inc. is included because its periodic payment plans held assets during the report period, but not after 2004.

³⁹ See *supra*, Table 2.

Chart 7: Periodic Payment Plan Assets by Sponsor (in Millions)



Due to the longevity of periodic payment plans, with payments often extending over fifteen years, a plan can remain in operation for years after sales are terminated. Congress recognized this fact in Section 4(a)(2) of the Act, which provided that the prohibition on future issuance or sale of future periodic payment plans shall not “alter, invalidate, or otherwise affect any rights or obligations, including rights of redemption,” under any periodic payment plan sold before the termination date.⁴⁰ This can also be seen in the operations of sponsors during the report period.

More than half (5 out of 9 or 55%) of the sponsors in operation during the report period had ceased selling plans before 2002. Moreover, of the four sponsors who sold at some point during the report period, three ceased selling during the report period. Therefore, by the time of the effective date for the prohibition on future issuance and sale of periodic payment plans (8 out of 9) or close to 90% of the sponsors were no longer selling the product. This is illustrated below in *Table 3: Date on Which Sponsors Offering Periodic Payment Plans to New Investors during the Report Period Ceased Such Offers*.⁴¹

⁴⁰ See *supra*, Military Personnel Financial Services Protection Act at note 1, § 4(a)(2).

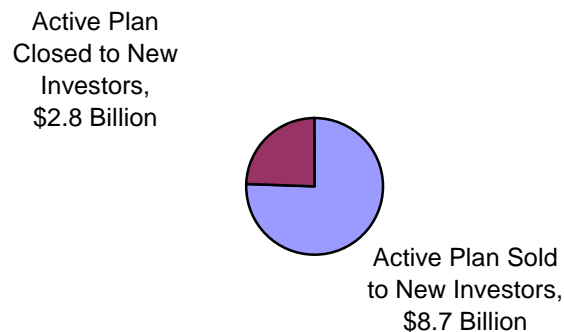
⁴¹ Sponsors’ responsive comments to Commission examinations on periodic payment plans.

Table 3: Date on Which Sponsors Offering Periodic Payment Plans to New Investors during the Report Period Ceased Such Offers

<u>Sponsor</u>	<u>Date Offers Ceased</u>
AIM Distributors	January 12, 2005
FMR Corp.	Closed by the Act
Franklin/Templeton Distributors	December 27, 2004
Pioneer Funds Distributor	October 11, 2005

As a result by 2006, almost a quarter of the assets in periodic payment plans were in plans that were no longer being sold. As of January 1, 2006, \$8.7 billion were in plans that were being sold, and \$2.8 billion were in plans that were no longer being sold. This is illustrated below in *Chart 8: Distribution of Periodic Payment Plan Assets between Plans Open and Closed to New Investors (June 2006)*.⁴²

Chart 8: Distribution of Periodic Payment Plan Assets between Plans Open and Closed to New Investors (June 2006)



By 2006 the population of periodic payment plan sponsors had shrunk dramatically. Moreover, assets were highly concentrated among the surviving sponsors, with two accounting for approximately 75%. Finally, by the beginning of 2006 only FMR Corp. continued to offer its plan to new investors.

C. Broker-Dealers

Periodic payment plans are sold to investors by broker-dealers. A broker, in general, is any person engaged in the business of effecting transactions in securities for the account

⁴² *Id.*

of others.⁴³ A dealer, in general, is any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.⁴⁴ To sell periodic payment plans, broker-dealers enter into dealer agreements with the plan's sponsor.

An entity that wishes to act as a broker-dealer, and that does not qualify for an exemption, must register both with the Commission and with at least one SRO.⁴⁵ Most non-bank registered broker-dealers also must become members of the Securities Investor Protection Corporation.⁴⁶ The Uniform Application for Broker Dealer Registration, Form BD, requires broker-dealers to disclose detailed information about their business, including their disciplinary history, if any.⁴⁷ Similar information about registered personnel of broker-dealers must be disclosed on Form U4, the Uniform Application for Securities Industry Registration. This information is maintained in the Central Registration Depository ("CRD"), which is operated by the NASD. Much of this information, including disciplinary history, is made publicly available by NASD through BrokerCheck. Broker-dealers must comply with the specific federal securities laws and rules thereunder, including: maintaining certain levels of net capital, depending on the nature of their business;⁴⁸ providing certain protections for customer funds and securities;⁴⁹ complying with regulations governing their books and records,⁵⁰ and disclosing specific transactional information to customers.⁵¹ The Commission has

⁴³ Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4).

⁴⁴ *Id.* § 3(a)(5), 15 U.S.C. § 78c(a)(5).

⁴⁵ *See* Securities Exchange Act of 1934 § 15(b)(8), 15 U.S.C. §78o(b)(8).

⁴⁶ *See* Securities Investor Protection Act of 1970 § 3(a)(2), 15 U.S.C. § 78ccc(a)(2).

⁴⁷ *See*, 17 C.F.R. 249.501 as last amended in Release No. 34-41672, 64 F.R. 42594 (1999). *See also*, The "Uniform Application for Broker Dealer Registration," or "Form BD," requires broker-dealers to disclose information regarding their business organization, control persons, types of business in which they engage, disciplinary history, and other additional relevant matters. The "Financial and Operational Combined Uniform Single Report," or "FOCUS Report," requires broker-dealers to report their capital structure, financial status, revenues, and additional relevant matters.

⁴⁸ Net Capital Requirement for Brokers or Dealers, 17 C.F.R. 240.15c3-1 as amended in Release No. 34-49830, 69 F.R. 34428 (2004).

⁴⁹ Customer Protection – Reserves and Custody of Securities, 17 C.F.R. 240.15c3-3 as last amended in Release No. 34-50295, 69 F.R. 54182 (2004).

⁵⁰ Records to be Made by Certain Exchange Members, Broker-dealers, 17 C.F.R. 240.17a-3 as amended by Release No. 34-49830, 69 F.R. 34428 (2004); Records to be Preserved by Certain Exchange Members, Broker-dealers, 17 C.F.R. 240.17a-4 as amended by Release No. 34-49830, 69 F.R. 34428 (2004); and Reports to Be Made by Certain Brokers-Dealers, 17 C.F.R. 240.17a-5 as amended by Release No. 34-49830, 69 F.R. 34428 (2004).

⁵¹ Confirmation of Transactions, 17 C.F.R. 240.10b-10 as amended in Release No. 34-51808, 70 F.R. 37496.

authority to impose additional disclosure requirements on broker-dealers pursuant to Section 15(c)(2) of the Securities Exchange Act of 1934.⁵² Broker-dealers must also comply with the anti-fraud provisions of the federal securities laws,⁵³ and rules that the Commission has promulgated thereunder.⁵⁴ Moreover, broker-dealers are subject to statutory disqualification standards and the Commission's disciplinary authority, which are designed to prevent persons with an adverse disciplinary history from becoming, or becoming associated with, registered broker-dealers.⁵⁵

In addition to their regulation by the Commission, broker-dealers are regulated by SROs,⁵⁶ such as the NASD.⁵⁷ As members of the NASD, broker-dealers must observe high standards of commercial honor and just and equitable principles of trade.⁵⁸ The SROs also have authority to adopt rules that are in accordance with just and equitable principles of trade. Broker-dealers must comply with NASD rules and regulations requiring them, among other things, to employ principals and sales agents that have successfully completed appropriate qualifying examinations (sales agents are known in the securities business as “registered representatives”);⁵⁹ to supervise these agents;⁶⁰ and to provide them with appropriate continuing education.⁶¹ Broker-dealers also have certain disclosure requirements under SRO rules. NASD requires its members recommending the purchase or sale of a mutual fund to a customer, to disclose all material facts to the customer. Material facts may include, but are not limited to, the fund's investment objective; the fund's portfolio, historical income, or capital appreciation; the fund's expense ratio and sales charges; risks of investing in the fund relative to other investments; and the fund's hedging or risk amelioration strategies. Disclosure of these and other facts concerning a proposed investment is required if the

⁵² See Securities Exchange Act of 1934 §15(c)(2), 15 U.S.C. §78o(c)(2).

⁵³ See, e.g., Securities Act of 1933 §17, 15 U.S.C. § 77q; Securities Exchange Act of 1934 §§9(a), 10(b), § 15(c)(1) and (2), 15 U.S.C. §§ 78i, 77j, and 78o .

⁵⁴ See, e.g., Employment of Manipulative and Deceptive Devices, 17 C.F.R. 240.10b-5 as adopted in Release No. 34-3230, 13 F.R. 8177 (1942).

⁵⁵ See Securities Exchange Act of 1934 §§ 3(a)(39), 15(b)(4), and 15(b)(6) ; 15 U.S.C. §§ 78c(a)(39), 78o(b)(4), and 78o(b)(6).

⁵⁶ Securities Exchange Act of 1934 §19, 15 U.S.C. §78s.

⁵⁷ NASD is a registered SRO, and as such is subject to oversight by the Commission. See Securities Exchange Act of 1934 §§ 15A, §17(a) and (b), and §19; 15 U.S.C. §§ 78o-3, 78q, and 78s.

⁵⁸ NASD Conduct Rule 2110.

⁵⁹ NASD Membership and Registration Rules 1020 to 1040.

⁶⁰ NASD Conduct Rule 3010.

⁶¹ NASD Membership and Registration Rules 1120.

circumstances surrounding the investment decision lead one to believe the investor would regard a fact as material to his decision whether to invest in the fund.⁶²

When broker-dealers sell securities to investors they must comply with several important standards, including SRO suitability rules.⁶³ A broker-dealer must make recommendations to a customer that are suitable based on a customer's financial situation and needs as well as other securities holdings. Suitability gives rise to a legal obligation under the federal antifraud provisions, as well as an ethical duty under SRO rules.⁶⁴ This requirement has been construed to impose a duty of inquiry on brokers to obtain relevant information from customers relating to their financial situations⁶⁵ and to keep such information current.⁶⁶ Factors relevant to whether a recommendation is suitable include not only information about the customer, but also characteristics of the securities and strategy recommended. Customer-specific factors include, but are not limited to, the customer's age, financial status, investment objectives, and level of sophistication in financial matters. Factors relating to the securities and investment strategy include, but are not limited to, the nature of the securities, the concentration of securities in the customer's portfolio, the use of margin, and the frequency of trading.

Commission actions against broker-dealers for making unsuitable recommendations generally are brought under Securities Exchange Act of 1934 Section 10(b) and Rule 10b-5 thereunder.⁶⁷ Like many other actions for violating the antifraud provisions, the Commission must establish that there was a misrepresentation (or material omission) that was made with scienter.⁶⁸ In contrast to the Commission's actions against broker-dealers

⁶² See NTM No. 94-16 *NASD Reminds Members of Mutual Fund Sales Practice Obligations*; see also NTM No(s). 91-74 *Replacement of Certificates of Deposits by Bond Mutual Funds*, 93-87 *NASD Provides Guidance for Reinvestment of Maturing Certificates of Deposits in Mutual Funds*, and 95-80 *NASD Further Explains Members Obligations and Responsibilities Regarding Mutual Funds Sales Practices*.

⁶³ See e.g., NASD Rule 2310. Recommendations to Customers (Suitability) and NYSE Rule 405 Diligence as to Accounts.

⁶⁴ See Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. 95, 88th Cong., 1st Sess., at 238 (1963) ("Report of Special Study").

⁶⁵ *Gerald M. Greenberg*, Release No. 34-6320, 40 S.E.C. 133 (July 21, 1960) (holding that a broker cannot avoid the duty to make suitable recommendations simply by avoiding knowledge of the customer's financial situation entirely).

⁶⁶ See 17 C.F.R. 17a-3(a)(17)(i), which requires broker-dealers to update customer records, including investment objectives, at least every 36 months.

⁶⁷ See, e.g., *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978).

⁶⁸ See *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (holding that a mere breach of a fiduciary duty in connection with a securities transaction, without misrepresentation, is not a fraud for purposes of the federal securities laws). *Santa Fe* indicates that an unsuitable recommendation cannot serve as the basis for a fraud claim, unless the recommendation also entails an element of deception. Recklessness also provides a basis for finding scienter. See, e.g., *Edgar Alacan*, Release No. 34-49970, 83 S.E.C. 723 (Jul. 6, 2004) (Salesman was "recklessly indifferent" to whether his highly aggressive and speculative

brought under the Securities Exchange Act of 1934, Section 10(b) and Rule 10b-5; actions brought against broker-dealers under the Securities Act of 1933, Section 17 and under the SRO rules, do not necessarily require proof of scienter to establish a suitability violation.⁶⁹

The SRO rules are grounded in concepts of professionalism, fair dealing, and just and equitable principles of trade, rather than in fraud. This means that the broker-dealer must have reasonable grounds for believing that the recommended transaction is suitable for the customer on the basis of information furnished by the customer and after “reasonable inquiry” concerning the customer’s investment objectives, financial situation, and needs.⁷⁰ A broker’s recommendations must be consistent with the customer’s “best interests, and must not be inconsistent with the customer’s financial situation.”⁷¹ Finally, a recommendation is not suitable merely because the customer acquiesces in the recommendation.⁷² The Commission and the SROs vigorously enforce these anti-fraud and suitability standards.

During the report period, approximately 127 broker-dealers sold periodic payment plans.⁷³ This represented only a small portion of the total population of broker-dealers. In 2006 there were 5,029 registered broker-dealers conducting a retail business.⁷⁴ Therefore, the broker-dealers that sold periodic payment plans during the report period represented only approximately 2.4% of the relevant broker-dealer community at the time the Act was enacted.⁷⁵ This is illustrated below in *Chart 9: Broker-Dealers Selling*

recommendations were consistent with the non-speculative investment objectives of his customers and therefore acted with scienter).

⁶⁹ See, e.g., Securities Act of 1933 §17, 15 U.S.C. §77q and *In re Jack H. Stein*, Release No.34- 47335, 79 S.E.C. 1777 (Feb. 10, 2003) (“Scienter is not an element for finding a violation of the NASD suitability rule.”); *In re John M. Reynolds*, Exchange Act Release No. 34-30036 50 S.E.C. 805(Dec. 4, 1991) (scienter unnecessary to establish excessive trading under NASD rules).

⁷⁰ *In the Matter of Dane S. Faber*, Release No. 34-49216, 82 S.E.C. 459 (Feb. 10, 2004) (SEC review of NASD disciplinary proceeding).

⁷¹ *Id.*

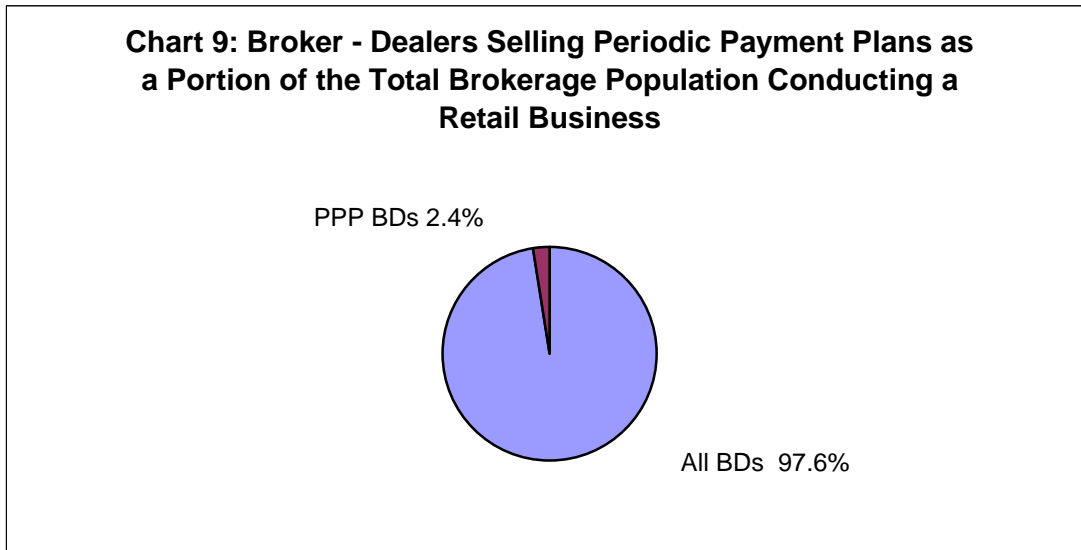
⁷² *Id.*

⁷³ This is an approximate number because several broker-dealers sold for more than one sponsor, and in some cases selling broker-dealers have merged or been sold to another firm. While many of these issues have been resolved, it is possible that some small portion of the 127 firms continue to represent duplications.

⁷⁴ NASD website: <http://www.nasd.com/PressRoom/Stastics/index.htm>.

⁷⁵ As a practical matter the portion of registered broker-dealers that sold periodic payment plans is probably less than 2.4%. The percentage given in the text compares all broker-dealers selling periodic payment plans over a five-year period to the number of all registered broker-dealers as of the end of the report period. Due to firms entering and leaving the business, acquisitions, mergers, and other events, the total number of registered broker-dealers during the five-year report period was probably greater than 5,029.

*Periodic Payment Plans as a Portion of the Total Brokerage Population Conducting a Retail Business.*⁷⁶



To sell periodic payment plans, broker-dealers entered into dealer agreements with the plan sponsors. Among other things, these agreements provide for the compensation the broker-dealers will receive for making sales. For example, in the prospectus for the *Fidelity Destiny Plans*,⁷⁷ it stated that:

Commissions ranging from 41.7% to 92.4% of the total [front end load paid by the investor⁷⁸] will be paid to authorized investment broker-dealer firms and mutual fund dealers that are members of the NASD and have executed a Destiny Selling Dealer Agreement with the Sponsor. From time to time the Sponsor may increase the commissions paid to broker-dealer firms to 100%. 12b-1 fees may also be paid to the broker-dealers.

As a result of these arrangements, the selling broker receives a significant portion of the sales load charged to the investor. In addition, the selling broker may continue to receive

Nonetheless, while 2.4% is probably at the high end as a percentage, it illustrates the order of magnitude of selling firms.

⁷⁶ Sponsors' responsive comments to Commission examinations on periodic payment plans.

⁷⁷ *Fidelity Systematic Investment Plans: Destiny Plans I:N*; Prospectus (November 29, 2005). The 2005 prospectus is used herein because the plans are now closed to new investors due to passage of the Act.

⁷⁸ The prospectus uses the term "Creation and Sales Charges," which it states elsewhere, are "sometimes called a 'front-end load.'"

12b-1 fees after the sale had been made.⁷⁹ The revenues obtained by broker-dealers through sales charges and 12b-1 fees on periodic payment plans are described below.

IV. BROKER-DEALERS' REVENUES GENERATED IN THE SALE OF PERIODIC PAYMENT PLANS

A. Revenues from Sales of Period Payment Plans

In Section 4(c)(3) of the Act, Congress directed the Commission to describe the revenues generated by brokers-dealers in the sale of periodic payment plan certificates over the report period. Set out below are the total revenues generated by brokers or dealers during the report period, revenues generated by the nine dominant firms, and revenues classified by whether the plan was open or closed to new investors during 2006.

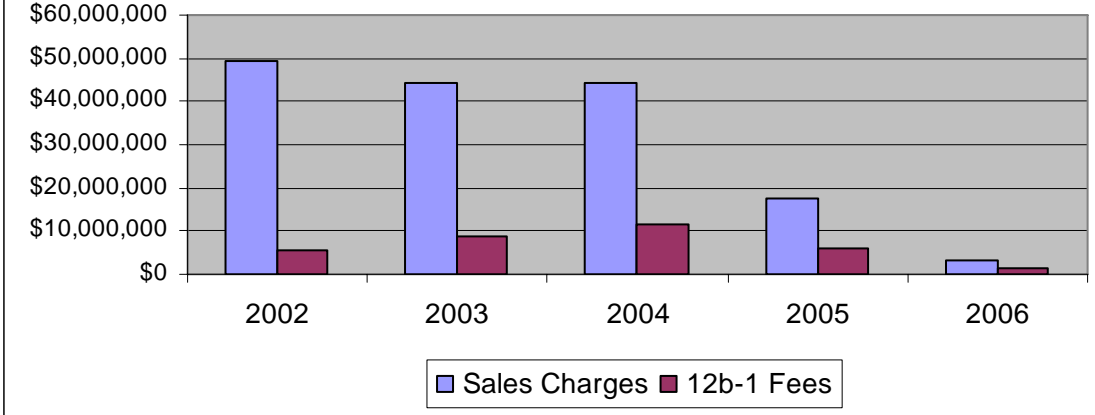
Periodic payment plan sponsors reported paying to 127 brokers-dealers total revenues of \$191,880,832 during the report period.⁸⁰ Of this amount, \$159,103,583 constituted sales charges and \$32,777,249 constituted 12b-1 fees. The bulk of this revenue was paid to broker-dealers during the early years of the report period. In 2005 revenues related to periodic payment plans fell off sharply. Then in 2006, they fell off again. This decline in revenues related to periodic payment plans in the years immediately prior to passage of the Act is illustrated below in *Chart 10: Broker-Dealers' Yearly Revenues from Periodic Payment Plans from Sales Charges and 12b-1 fees (2002–2006)*.⁸¹

⁷⁹ 17 C.F.R. 270.12b-1 allows investment companies to use their assets to finance sales related expenses. See Release No. 11414, 45 F.R. 73898 (November 7, 1980).

⁸⁰ The revenues reported herein are based on information available as of March 2007. The sponsor that offered periodic payment plans during 2006 has indicated it may seek adjustments from several broker-dealers for a number of reasons. Following these adjustments, final revenues may differ from those reported herein.

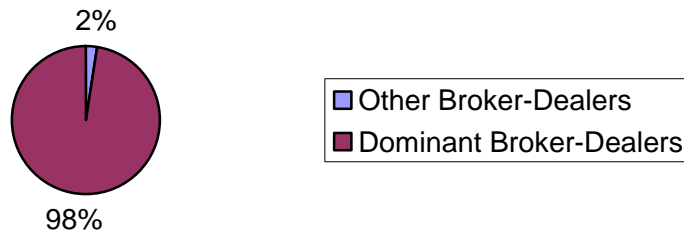
⁸¹ See *supra*, at note 41 sponsors' responsive comments to the Commission examinations.

Chart 10: Broker - Dealers' Yearly Revenues from Periodic Payment Plans from Sales Charges and 12b-1 Fees (2002-2006)



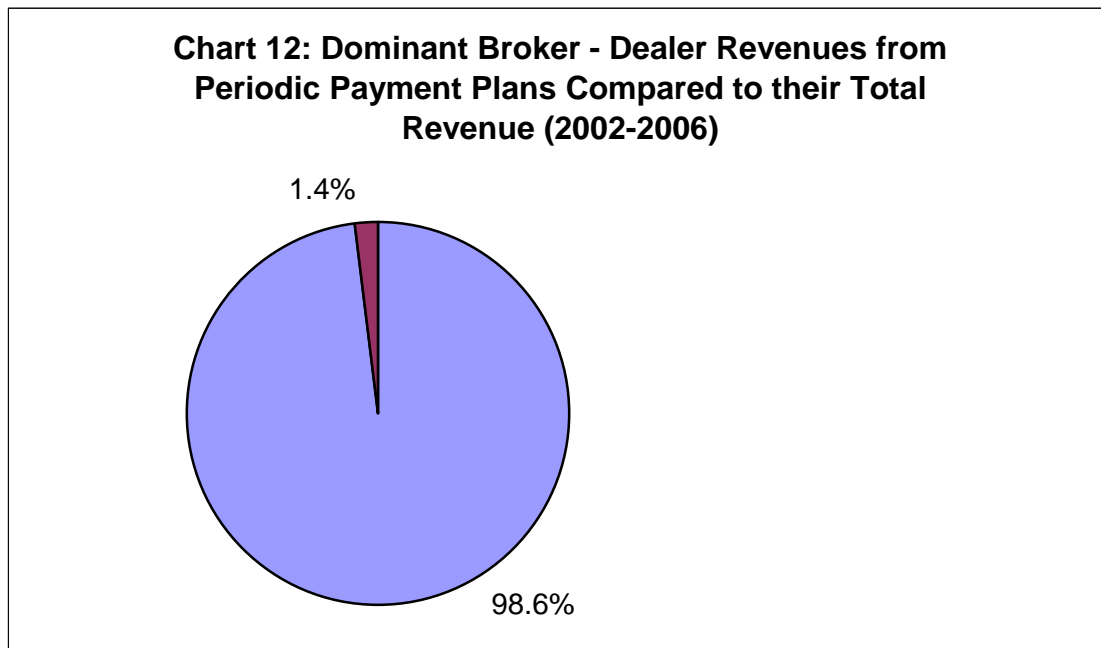
Periodic payment plan sponsors reported paying the nine dominant brokers-dealers revenues of \$186,546,572 during the report period. Of this amount, \$156,709,228 constituted sales charges and \$29,837,344 constituted 12b-1 fees. Therefore, the dominant firms received approximately 98% of the total revenues generated by broker-dealers in the sale of periodic payment plans. The dominant position of these nine firms is illustrated below in *Chart 11: Dominant Broker-Dealers' Revenue from Periodic Payment Plans Compared to Revenues of Other Broker-Dealers from Periodic Payment Plans (2002-2006)*.⁸²

Chart 11: Dominant Brokers-Dealers' Revenue from Periodic Payment Plans Compared to Revenues of Other Brokers-Dealers from Periodic Payment Plans (2002-2006)



⁸² *Id.*

While the dominant broker-dealers received the bulk of the revenue generated from the sale of periodic payment plans, this revenue generally represented only a small portion of the firms' total revenue. In fact, over the five years of the report period, revenues from periodic payment plans represented only approximately 1% of the dominant firms' aggregate total revenues. Their revenues totaled \$13,271,309,802;⁸³ whereas their revenues from periodic payment plans equaled \$156,709,227 or \$188,627,646, if 12b-1 fees are included. Hence, revenue from periodic payment plans represented only 1.2% to 1.4% of their total revenue. This is illustrated below in *Chart 12: Dominant Broker-dealers' Revenue from Periodic Payment Plans Compared to Their Total Revenue (2002-2006)*.⁸⁴

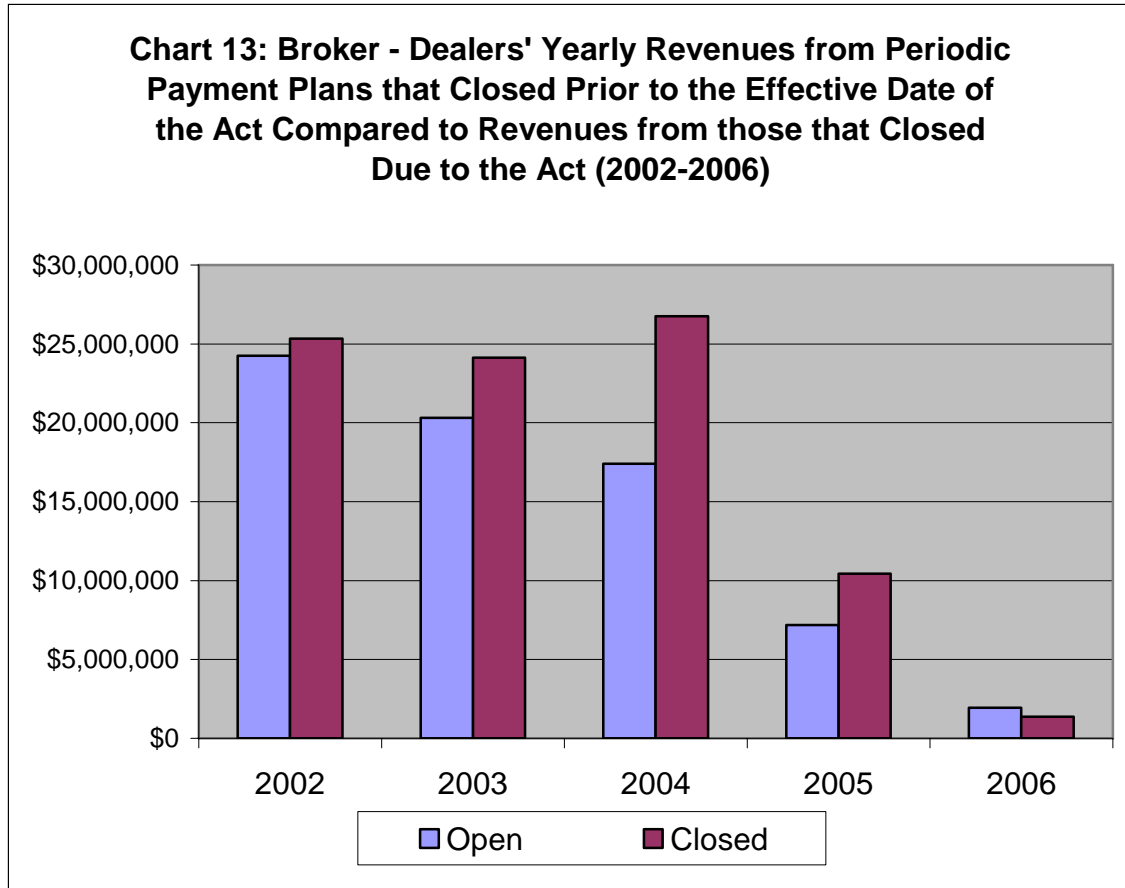


As previously noted, many of the periodic payment plans in existence during the report period ceased sales either before or during the period. This development is reflected in the revenue generated by broker-dealers. Indeed, more revenue was paid to broker-dealers by plans that had closed by the end of the report period, than by plans that remained open. Over the report period, plans that remained open into 2006 had paid broker-dealers revenues from sales charges (*i.e.*, non-12b-1 revenue) of \$71,067,829; while those that had closed paid \$88,035,754. In both cases, however, revenue declined

⁸³ This information was obtained from FOCUS Filings part II, Item 4030. *See supra* FOCUS Filings at note 47.

⁸⁴ *Id.*

sharply by the end of the report period. This is illustrated below in *Chart 13: Broker-Dealers' Yearly Revenues from Periodic Payment Plans that Closed Prior to the Effective Date of the Act Compared to Revenues from those that Remained Open to the Effective Date of the Act (2002-2006)*.⁸⁵



In summary, by 2006, the revenues obtained by broker-dealers from sales of periodic payment plans had decreased sharply. While a small number of firms dominated sales with more than 98% of the revenues generated from such sales, that revenue represented only approximately 1% of their total revenue from other products.⁸⁶ Much of the revenue generated by broker-dealers from the sale of periodic payment plans was from plans that had closed by the end of the report period. Finally, all revenue from periodic payment plans had declined significantly by the end of the report period.

⁸⁵ *Id.*

⁸⁶ *See supra*, Chart 12.

B. Products Marketed to Replace Sales of Period Payment Plans

In Section 4(c)(3) of the Act, Congress directed the Commission to describe any products marketed by brokers-dealers to replace the revenue generated from the sales of periodic payment plan certificates prohibited by the Act. The dominant broker-dealers have indicated that they are not marketing any products to replace periodic payment plans. The Staff tested these assertions and found no evidence inconsistent with these claims.⁸⁷

In preparation for this Report, the Staff asked the dominant broker-dealers to: “identify any products that you have marketed to replace the revenue generated from the sales of periodic payment plan certificates that are now prohibited under the Act.” The firms uniformly responded that they have not marketed any specific product to replace the revenue generated from sales of periodic payment plans.⁸⁸

To test these assertions, the Staff compared the revenue received by the dominant broker-dealers from sales of periodic payment plans during the report period to their total revenue, as reported in their periodic FOCUS Reports.⁸⁹ The Staff sought to determine whether any of the dominant firms would face such a significant and immediate shortfall in revenue following the prohibition on sales of periodic payment plans, so as to call into question its claim that no replacement products were being marketed. As previously noted, in the aggregate, dominant firms received only approximately 1% of their total revenue from periodic payment plans.⁹⁰ This would suggest that the firms were ready to absorb the loss of revenue from periodic payment plans. Nonetheless, when viewed individually the Staff determined that the firms relevant to this inquiry⁹¹ could be classified into three groups.

The first group of dominant broker-dealers received only a tiny portion of their total revenue from sales of periodic payment plans. For three of the firms, revenue from sales of periodic payment plans consistently represented less than 1% of the firm’s total revenues throughout the report period. The fourth firm derived 3% of its total revenue from sales of periodic payment plans in 2002, but that percentage declined through the report period to less than 1% in 2005 and 2006.

⁸⁷ As described below, in Section VI.D.4 of this Report, while the Staff did not identify any products marketed firm-wide to replace the revenue from periodic payment plans, it did identify certain possible suitability or sales practice issues involved in brokers’ recommendations regarding existing investments in periodic payment plans.

⁸⁸ While all of the firms indicated that they were not marketing any products to replace periodic payment plans, one firm indicated that it was seeking to expand its line of insurance products, fixed annuities, and advisory services. According to financial statements provided to the Staff, the sale of annuities and the provision of advisory services appear to have expanded the most.

⁸⁹ See *supra*, at note 47, FOCUS Reports.

⁹⁰ See *supra*, Chart 12.

⁹¹ Two of the nine broker-dealers that dominated sales of periodic payment plans during the report period have gone out of business.

The second group of dominant broker-dealers received a moderate portion of their total revenue from the sale of periodic payment plans at some point during the report period. There were two firms in this group. For both firms, the percentage of total revenue represented by sales of periodic payment plans started at a moderate level and then fell through the report period. For one firm, revenue from sales of periodic payment plans represented 44% of its total revenue in 2002, but the percentage fell through the report period to only 2% in 2006. The other firm began the report period with 18% of its total revenue from sales of periodic payment plans, but this percentage fell through the report period to 4.5% in 2005 and zero in 2006.

Finally, the third group of dominant broker-dealers obtained a high portion of their total revenue from the sale of periodic payment plans at some point during the report period. There were two firms in this group. Both obtained in excess of 70% of their total revenues from the sales of periodic payment plans during at least two years within the report period. However, both ceased the sale of periodic payment plans prior to the end of the report period, and applicable revenues had significantly declined. One of the firms had ceased selling periodic payment plans in October 2004 and the other in April 2005. Periodic payment plans evidently played varying roles in the firms' businesses. Nonetheless, they all appear to have fully absorbed the decline in the business prior to the Act's prohibition on future sales.

V. REFUNDS OF PAYMENTS MADE BY MILITARY PERSONNEL

In Section 4(c)(1) of the Act, Congress directed the Commission to describe any measures taken by a broker-dealers to voluntarily refund payments made by military service members on any periodic payment plan certificate, and the amounts of such refunds. The Staff found no instances where broker-dealers had voluntarily refunded payments, however pursuant to the settlement enforcement order noted below, one of the dominant broker-dealers, First Command, indicated that it is offering refunds to military service members.

First Command has offered refunds pursuant to the terms of a settled enforcement order issued by the Commission and a companion settlement of an NASD disciplinary proceeding.⁹² The misleading sales practices that gave rise to this case are discussed in Section VI.A.1 of this Report, below. In the enforcement and disciplinary proceedings, First Command was ordered to pay \$12 million to be used for a customer-restitution program, under the management of an independent consultant.⁹³ Restitution was to be made to all First Command customers who had purchased and terminated a periodic payment plan between January 1, 1999 and December 15, 2004, the date of the

⁹² See *supra*, *First Command Financial Planning, Inc.* at note 3.

⁹³ The Commission ordered First Command to fund an investor education program for military personnel and their families. *Id.* The investor-education program was to receive \$12 million, less the full cost of any restitution payments. As of December 11, 2006, as detailed in the independent consultant's final report, First Command paid a total of \$6,813,223 to the investor education program.

Commission's order. The amount of restitution was to be measured by an amount equal to the effective sales charges in excess of 5% of the amounts paid by any given customer, plus interest. The independent consultant was required to file periodically an Independent Consultant's Report on Restitution and Policies and Procedures to both the Commission and NASD. The final report was dated December 11, 2006.

In its final report, the independent consultant noted that 79.58% of customers eligible for restitution had been paid 87.25% of the restitution amount. The original mailing of a letter and declaration to 13,609 eligible customers occurred on February 11, 2005. Additional names were added to the database as they became known. Customers who did not respond were sent follow-up letters. As of November 15, 2006, the final adjusted number of customers eligible for restitution was determined to be 13,628, having total claims of \$5,184,138. As of December 1, 2006, the independent consultant had issued 10,845 restitution checks to investors with a total value of \$4,523,324. Approximately \$717,759 remains in the independent consultant's account, of which \$660,814 is still owed to investors that have not been located. The independent consultant concluded that First Command had complied with the customer-restitution program. Importantly, it also noted that First Command remained committed to continue processing and paying claims. That commitment extended to eligible claimants who contacted either the independent consultant or First Command.

VI. PROBLEMS IN SALES OF SECURITIES TO MILITARY PERSONNEL

In Section 4(c)(2) of the Act, Congress directed the Commission to describe the sales practices of broker-dealers on military installations over the report period. To fulfill this mandate, the Commission believes it should address a broader question. That is, what are the sales practices of broker-dealers in the sales of securities to military personnel? This approach captures sales activity both on the premises of military installations, and in sales offices located off-base. Many sales of securities to military personnel take place off-base, often in sales offices immediately outside the gates of military installations. Therefore, while more inclusive than the Report mandated by the Act, the Commission believes this approach will address the concerns leading to the Congressional mandate set forth in Section 4(c).

In 2004, when potential problems in sales of securities to military personnel came to the attention of the Commission, the Staff determined that the military community should be identified as an at-risk group. Following this determination, the Staff quickly deployed resources from multiple functional programs of the Commission, including enforcement and examinations, and initiated a coordinated approach with the NASD to protect members of the military from abusive sales practices. These efforts continued from 2004 through the preparation of this report. In addition, information for this Report was collected from the nine dominant broker-dealers in the periodic payment plan market. The problems in sales of securities to military personnel identified through these efforts are discussed below.

A. Problems Identified in Commission Enforcement Actions

To enforce the federal securities laws, the Commission brings enforcement actions. These include both administrative proceedings⁹⁴ and civil actions filed in federal court.⁹⁵ Remedies available to the Commission in administrative proceedings include orders that the respondent cease and desist from further violations,⁹⁶ that it disgorge ill-gotten gains,⁹⁷ and that it pay a penalty.⁹⁸ Remedies available in civil actions include injunctions that prohibit the defendant from engaging in future violations,⁹⁹ that it disgorge ill-gotten gains,¹⁰⁰ and that it pay a penalty.¹⁰¹ Recently, the Commission has brought two significant enforcement actions that identified problems in sales of securities to military personnel.

1. *In the Matter of First Command Financial Planning, Inc.*

On December 15, 2004, the Commission instituted an administrative enforcement proceeding against First Command,¹⁰² a registered broker-dealer based in Fort Worth, Texas, whose customer base consisted almost entirely of active-duty and retired U.S. military personnel. In an action coordinated with the NASD,¹⁰³ the Commission alleged that First Command used misleading sales materials to offer and sell periodic payment plans.

The Commission found that First Command maintained sales offices near U.S. military bases worldwide and claimed that its customers included approximately 40% of the active-duty general officers and approximately one-third of the commissioned officers.

⁹⁴ See e.g., Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1; Securities Exchange Act of 1934 §15, 15 U.S.C. §78o.

⁹⁵ See e.g., Securities Act of 1933 §20, 15 U.S.C. §77t and Securities Exchange Act of 1934 §21, 15 U.S.C. §78u.

⁹⁶ See e.g., Securities Act of 1933 § 8A, 15 U.S.C. §77h-1; Securities Exchange Act of 1934 § 21C, 15 U.S.C. §78u-3.

⁹⁷ See e.g., Securities Act of 1933 §8A(e), 15 U.S.C. §77h-1; Securities Exchange Act § 21C(e), 15 U.S.C. §78u-3.

⁹⁸ See e.g., Securities Exchange Act of 1934 § 21B, 15 U.S.C. §78u-2.

⁹⁹ See e.g., Securities Act of 1933 §20(b), 15 U.S.C. §77t and Securities Exchange Act of 1934 §21(d), 15 U.S.C. §78u.

¹⁰⁰ See e.g., Securities Exchange Act of 1934 §21(d)(5), 15 U.S.C. §78u.

¹⁰¹ See e.g., Securities Act of 1933 §20(d), 15 U.S.C. §77t and Securities Exchange Act of 1934 §21(d)(3), 15 U.S.C. §78u.

¹⁰² See *supra*, *First Command Financial Planning, Inc.* at note 3.

¹⁰³ See *infra*, Section VI.C discussion on NASD action.

The vast majority of First Command's sales agents were retired military officers. This firm was responsible for approximately 90% of all sales of periodic payment plans.

The Commission also found that as with investors in other periodic payment plans, if the investor in a plan sold by First Command failed to make all of the scheduled payments, the effective sales load could be substantially higher than the average paid in a conventional front-end load equity fund. The Commission found that historically, approximately 43% of First Command's customers made at least 180 scheduled payments. The remainder failed to complete 180 payments and, consequently, many of them paid loads substantially higher than the approximate average for a conventional-load equity fund. In the worst case, those who discontinued payments after one year paid a 50% sales load.

In addition, the Commission found that First Command, since at least January 1999, offered and sold plans using carefully-worded sales scripts that made misleading comparisons between periodic payment plans and other mutual-fund investments. For example, First Command claimed that periodic payment plans are the only funds that are designed for dollar-cost averaging investors, that no-load funds were primarily for "speculative" investors, and that transactions by speculative investors reduced the opportunity for the no-load fund's manager to make opportune investments for the fund. In reality, many long-term investors invest in no-load funds, and many no-load funds maintain dollar-cost-averaging programs allowing investors to make relatively small periodic contributions. The Commission found that First Command's sales materials also contained misleading statements and omissions concerning the cost of no-load funds, and the availability of the Thrift Savings Plan, the Federal Government-sponsored retirement savings and investment plan, which offers military investors many of the features of a contractual plan, but at a lower cost. The Commission further found that, in light of the relatively low completion rate in its periodic payment plans, First Command misrepresented the efficacy of the upfront load in ensuring that investors remain committed to the contractual plan.

The Commission found that First Command's conduct violated Section 17(a)(2) of the Securities Act of 1933, an anti-fraud provision. In settlement of these actions, without admitting or denying the Commission's findings, First Command agreed to pay \$12 million in disgorgement and prejudgment interest to be used to reimburse customers¹⁰⁴ and to fund an NASD-managed investor-education program for members of the U.S. military and their families.¹⁰⁵ In October 2004 First Command stopped selling periodic payment plans.

¹⁰⁴ See *supra*, Section V. of this Report.

¹⁰⁵ See *infra*, Section VII.A.4 of this Report.

2. *SEC v. American-Amicable Life Insurance Company of Texas et al.*

On August 3, 2006, in the United States District Court for the Southern District of California, the Commission filed a civil enforcement action against American-Amicable Life Insurance Company of Texas; Pioneer American Insurance Company; and Pioneer Security Life Insurance Company (collectively, "American-Amicable"),¹⁰⁶ all based in Waco, Texas. The Commission charged American-Amicable with securities law violations based on its deceptive sales of investments to military personnel.

The Commission alleged that American-Amicable targeted military personnel with a deceptive sales program, known as the "Building Success" system, that misleadingly suggested that investing in the company's product, Horizon Life, would make one a millionaire. Since 2000, approximately 57,000 members of the United States military services had purchased the product. Unlike insurance products that are legitimately offered to a wide range of potential buyers with a potential interest in a product's insurance features, Horizon Life was targeted at military personnel who, because of their access to low-cost government sponsored coverage, had little or no interest in insurance. Instead, American-Amicable represented Horizon Life to military personnel as a security and a wealth-creating investment.

The Commission also alleged that as a material element of its marketing, American-Amicable's senior staff trained sales agents to hold themselves out as "financial advisers" or "financial coaches." Purporting to play that role, the sales agents then allegedly misled military personnel to believe they could become millionaires if they invested in Horizon Life. At the same time, the agents allegedly denigrated other investment alternatives, claiming that mutual funds, bank savings accounts and government bonds were not sensible investments compared to Horizon Life. Although the written materials ultimately provided to investors apparently accurately described the Horizon Life product, the company's deceptive sales pitch did not. Contrary to the representations, the overwhelming majority of military personnel who purchased Horizon Life earned little or nothing from their investment.

The Commission's complaint charged American-Amicable with violating Sections 17(a)(2) and (3) of the Securities Act, anti-fraud provisions. Without admitting or denying the allegations, American-Amicable agreed to be enjoined from further violations of these provisions, and to pay disgorgement of \$10 million, which will be distributed to the approximately 57,000 military personnel who invested in Horizon

¹⁰⁶ *SEC v. American-Amicable Life Insurance Company of Texas; Pioneer American Insurance Company; and Pioneer Security Life Insurance Company*, Case No. 06-CV-1553 JAH WMC (S.D. Cal. filed August 3, 2006), Litigation Release No. 19791 (August 3, 2006).

Life.¹⁰⁷ As part of the settlement, American-Amicable agreed to discontinue sales of Horizon Life and terminate the “Building Success” system.

B. Problems Identified in Commission Examinations

To foster preventive compliance by securities firms, and keep the Commission informed of developments in the securities business and markets, the Staff conduct examinations of broker-dealers.¹⁰⁸ In examinations, the Staff review a broker-dealer’s records, interview its associated persons, and seek to determine if the entity and its associated persons are in compliance with their regulatory obligations under the federal securities laws, rules and regulations thereunder, and the applicable rules of SROs. In light of the confidential nature of the Commission’s examinations, this Report does not reveal any names of examined firms.

The Commission utilizes a risk-based approach to examinations to ensure that its resources are appropriately focused on the areas of greatest need. Through an internal process, emerging risks are identified and examinations are directed toward addressing those risks. In 2004, when the Commission determined that the military community should be identified as an at-risk group, two separate programs of risk-based examinations were directed at sales of securities to the military.

1. Risk-Based Examinations of Broker-Dealers That Sell Periodic Payment Plans

Following indications from the enforcement investigation and proceeding against First Command that military personnel may be at risk, the Staff selected four additional broker-dealers for examination. The firms were selected because they sold significant amounts of periodic payment plans. Three of the four specialized in sales to the military. Like *First Command*, the firms examined in these reviews discontinued sales of periodic payment plans prior to enactment of the Act.

The Staff observed that several of these firms generally sold periodic payment plans to lower-ranking enlisted military members. As with other plans, these products called for a 50% load paid out in the first 12 installments, with no additional load after that, and consisted of at least 120 payments to be made monthly over ten years. Although the examinations of these firms did not reveal the sort of systemic misrepresentations found in the *First Command* case, they did show that very few low-ranking enlisted members

¹⁰⁷ The Commission’s settlement with American-Amicable was part of a global settlement of claims brought by the Commission, state insurance regulators led by the Georgia Department of Insurance and the Texas Department of Insurance, and the United States Attorney’s Office for the Eastern District of Pennsylvania. The claims by state insurance regulators were based on state insurance and consumer protection laws, and the claims by the United States Attorney were based on civil claims of mail and wire fraud. The settlement with the other regulators provided additional relief, which the other regulators valued at approximately \$60 million.

¹⁰⁸ Securities Exchange Act of 1934 §17(a)(1), 15 U.S.C. §78q.

made at least 120 payments. At one firm, fewer than 10% completed their plans. As a result, on average, low-ranking enlisted members paid loads greater than 10%. This rate was significantly higher than the rate they would have paid if they had purchased mutual-fund shares with a conventional load.

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

2. Risk-Based Examinations of Broker-Dealers That Sell Other Securities Products to Military Personnel

The Staff also initiated a second risk-based examination review of how broker-dealers sell securities products to military personnel. This review was broader than the review that focused on sales of periodic payment plans (described above), and encompassed sales of all securities products, such as mutual funds, variable annuities, and stocks and bonds.

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

In general, the Staff noted deficiencies in the internal controls and supervisory systems at several firms. In the case of several offices located overseas, it was unclear whether some sales agents had ever received any type of supervisory oversight or compliance training. Internal controls were lacking in that customer account information was incomplete, records of customer activity were incomplete or not available, correspondence files were incomplete, and in one case, several customer account forms were signed in blank. These deficiencies were brought to the attention of the firms for immediate correction.

Importantly, while the deficiencies noted in these examinations were serious, they do not reveal the type of systemic issues involving a distinctly military audience that the Commission has found in regards to periodic payment plans and the "Building Success" system. In other words, while these reviews did not find serious sales practice abuses, they helped define the scope of the emerging risk. Specifically, the reviews indicated that

the abusive activity with respect to securities sales appeared to be largely concentrated in the sale of periodic payment plans or products similar to those marketed by American-Amicable.

C. Problems Identified by NASD's Oversight

As an SRO governed by the federal securities laws, the NASD enforces compliance by its members with the federal securities laws, rules and regulations thereunder, and its own rules.¹⁰⁹ As noted above, NASD took disciplinary action against First Command in connection with its sales of periodic payment plans to military service members and has investigated other firms that sold or prepared sales literature about such plans. In December 2004, in an action that was coordinated with the Commission, the NASD censured and fined First Command \$12 million in connection with the sale of periodic payment plans to military personnel. NASD made findings that First Command used sales scripts that contained misleading statements and omissions about the plans including: (i) claims that the plan's 50% first year sales load increased the likelihood investors would complete their plan payments, when First Command had data that showed that only 43% of the its customer completed the plans; (ii) comparisons between the plans and other mutual fund investments, including telling investors that no-load mutual funds were primarily for speculators and had some of the highest long-term costs, and (iii) the availability of the Thrift Savings Plan, which offers military investors many of the same features of a Plan at lower costs. From the \$12 million, First Command was ordered to pay restitution to thousands of customers,¹¹⁰ and the remaining funds were paid to the NASD Investor Education Foundation, for the investor education needs of members of the United States military and their families.¹¹¹

In addition to its action involving First Command, the NASD has investigated periodic payment plan sales to military personnel by two other smaller brokerage firms. The NASD continues to focus on, among other things, the failure of each firm to have adequate supervisory systems to ensure (i) that investors had the financial capacity to complete the Plans and (ii) sales of such plans were conducted in compliance with Department of Defense regulations. In another matter, NASD investigated the distribution of periodic payment plan sales literature by member firms affiliated with a provider of such plans. NASD is focusing on whether that sales literature complied with NASD's advertising rules.

D. Possible "Switching" Identified

To prepare this Report, the Staff obtained information on the dominant broker-dealers' efforts to conduct sales activities on military installations or target uniformed military personnel. As previously noted, these broker-dealers were collectively responsible for

¹⁰⁹ See Securities Exchange Act of 1934 §19(g)(1), 15 U.S.C. §78s.

¹¹⁰ See *supra*, Section V.

¹¹¹ See *infra*, Section VII.A.4.

approximately 98% of the sales of periodic payment plans during the report period. If the broker-dealer had been the subject of an enforcement action relating to periodic payment plans, the Staff sought this information for the period following the enforcement action. Otherwise, the Staff sought the information for the five years of the report period.

Specifically, the Staff asked for copies of “any communications with the public, including advertising, sales literature, or correspondence” that the firm utilized during the report period to conduct sales activities on military installations or to target unformed military personnel. The Staff also asked whether the firm had received or been the subject of any of the following regarding sales of securities (including but not limited to sales of periodic payment plan certificates, mutual funds, variable insurance products, or penny stocks) on military installations:

- a) Customer complaints;
- b) Non-customer complaints or warnings (including complaints or warnings made by or brought to your attention by representatives of a base command, military police, military attorneys, or others);
- c) Claims in arbitration;
- d) Claims in litigation;
- e) Actions by military authorities to deny you or one or more of your registered representatives access to an installation;
- f) Actions by military authorities to declare you or one or more of your sales locations off-limits to military personnel;
- g) Findings or recommendations presented to you in writing by an SRO, state regulator, or other regulator in an inspection, examination, or investigation; or
- h) Disciplinary or enforcement actions brought against you or any of your registered representatives by an SRO, state regulator, or any other regulator?”

As a result of its review of the materials provided by the dominant firms in response to these requests, the Staff identified some issues that may be indicative of further problems in sales of securities to military personnel. Specifically, it identified instances where registered representatives have recommended that investors withdraw from a periodic payment plan to invest in another product. In some cases, it appears that the registered representative’s recommendation did not address the effect such a withdrawal would have on the effective sales load paid by the investor of the funds already invested in the plan.

These facts suggest possible issues with “switching,” which involves transactions where shares of a particular security are redeemed and all or part of the proceeds are used to purchase shares of another security.¹¹² Switching of mutual funds is of particular

¹¹² See *In re Leslie E. Rossello*, Release No. 34-43650, (Dec. 1, 2000); *In re Charles E. Marland & Co., Inc.*, Release No. 34-11065, 45 S.E.C. 632, 636 (October 21, 1974); *In re Thomas Arthur Stewart*, Release No. 34-3720, 20 S.E.C. 196 (August 6, 1945).

concern because these investments are generally meant to be long-term.¹¹³ Thus, switching of mutual funds is often evaluated under suitability standards. The NASD has stated that any recommendation from a broker-dealer that a customer switch mutual funds must not be based on incentives received by the broker.¹¹⁴ Switching among certain fund types may be particularly difficult to justify if the financial gain or investment objective to be achieved by the customer as a result of the switch is negated by the transaction fees associated with the switch.¹¹⁵ Thus, any recommendation to switch mutual funds is evaluated with regard to the net investment advantage to the investor.¹¹⁶

Given the unique sales compensation structure of periodic payment plans, the Staff believes that any recommendation to withdraw from a plan should take account of the resulting effective sales load that the investor would pay. The Staff and the NASD continue to look into these situations.

VII. LEGISLATIVE AND REGULATORY RECOMMENDATIONS TO FURTHER IMPROVE SALES PRACTICES ON MILITARY INSTALLATIONS

In Section 4(c)(2) of the Act, Congress directed the Commission to describe, after such consultation with the Secretary of Defense as the Commission considers appropriate,¹¹⁷

¹¹³ See *In re the Application of Kenneth C. Krull*, Release No. 34-40768, 68 S.E.C. 2227 (December 10, 1998), Release No. 34-41008, 69 SEC 62 (February 1, 1999) (SEC review of NASD disciplinary proceeding emphasized that a pattern of mutual fund switching presumptively violates NASD rules because trading in mutual fund shares on a short-term basis violates a salesman's responsibility for fair dealing.)

¹¹⁴ See *supra*, NTM No. 95-80 at note 62. See also *In re Leslie E. Rossello*, Release No. 43650, 73 S.E.C. 2627 (December 1, 2000) (finding that a registered representative violated Section 17(a) of the Securities Act, and Section 10(b) and Rule 10b-5 of the Exchange Act when she induced mutual fund switches for her benefit rather than that of her customers); See also *supra* at note 111, *In re Charles E. Marland & Co., Inc.*, 45 S.E.C. 632, 636 (pattern of recommending mutual fund switching exhibited in the facts of this case creates rebuttable presumption of unsuitability) and *In re Thomas Arthur Stewart*, 20 S.E.C. 196, 207 (finding that the broker violated NASD's suitability rule because it had a lack of reasonable grounds for recommending switching shares of mutual funds).

¹¹⁵ See *supra*, NTM No. 95-80 at note 62.

¹¹⁶ *Id.* See also, NTM No. 94-16, *NASD Reminds Members of Mutual Fund Sales Practice Obligations*.

¹¹⁷ In November 2005 the Government Accountability Office issued a report entitled: "*Financial Product Sales; Actions Needed to Better Protect Military Members*," GAO-06-23. The report made a number of recommendations, including that the Commission should designate staff to receive complaints from the Department of Defense, and conduct outreach to defense headquarters and installations to proactively learn of issues or concerns regarding product sales. The report also recommended that these staff should make use of any listings that the Department of Defense maintains of individuals and firms that have been sanctioned by the military for improper solicitation practices. To implement this recommendation the Staff designated the Associate Director - Chief Counsel of the Office of Compliance Inspections and Examinations as liaison to the Department of Defense. The NASD has also designated an individual to serve as liaison to the Department of Defense. The Commission's liaison has maintained contact with relevant officials in the Department of Defense; facilitated coordinated activities, such as the preparation of this report; monitored the Department of Defense's listing of sanctioned firms and individuals; and worked with the Department of Defense and Commission staff to enhance oversight of broker-dealers selling

any legislative or regulatory recommendations to improve the sales practices of broker-dealers on military installations. To respond to this directive, it is essential to discuss the legislative and regulatory initiatives that already are in place.

A. Legislative and Regulatory Initiatives Already in Place to Address Problems in Sales of Securities to Military Personnel

1. Prohibition of Sales of Periodic Payment Plans

The single most important initiative already in place to address problems in sales of securities to military personnel was the recent statutory prohibition on the future issuance or sale of periodic payment plans. As discussed above, the Staff observed many problems related to periodic payment plans. In particular, the low completion rate of many uniformed investors led to these investors paying sales charges far in excess of a conventional load. The problems associated with periodic payment plans are no longer a significant issue because of the statutory prohibition .

2. Initiatives by the Department of Defense

Following consultations with the Staff, the Department of Defense provided the Commission with a summary of their initiatives in this area:

Commercial Insurance Solicitation: The Department of Defense issued policy guidance to strengthen oversight of commercial life insurance and investment product sales on military installations. Department of Defense Instruction 1344.07, "*Personal Commercial Solicitation on DoD Installations*," was approved on March 30, 2006, and became effective on July 10, 2006, when it was published in the Code of Federal Regulations. The new instruction requires installations to report any withdrawal or suspension of solicitation privileges to their Service Headquarters and to the Office of the Secretary of Defense (OSD). OSD now maintains a Department of Defense-wide list of insurance, investment companies, and agents who are barred or banned from doing business on any Department of Defense installation. Installation commanders must review this list prior to approving any new requests to solicit on the installation. This list may be viewed at the *Personal Commercial Solicitation Report* "quick link" at www.commanderspage.com. Any changes to this list are also reported to appropriate state insurance and federal securities regulators.

The instruction also contains a policy on the use of non-governmental organizations to provide financial education to service members, and a policy to preclude commercial sponsorship of morale, welfare and recreations programs or events from being used to obtain personal contact information to foster future solicitations. Of particular note, on-base solicitors are now required to provide prospective clients with

securities in or near base communities. In addition, as described below in Section VII.A.4, the Commission's Office of Investor Education and Assistance has engaged in a proactive program of outreach and investor education in the military community. In these programs the Commission's staff has been vigilant for any indication of concerns regarding product sales to the military.

a *Personal Solicitation Evaluation* form that will provide feedback to installation officials on how the solicitation was conducted. The evaluation form is designed to detect policy violations and will help installations better enforce on-base commercial solicitation rules.

The military departments are currently revising their service regulations to incorporate new policies contained in DoDI 1344.07. The Air Force expects to finalize its new commercial solicitation policy guidance by the end of April. The Army, Navy and Marine Corps anticipate having their revised personal commercial solicitation regulations completed by the end of June.

Financial Readiness: The Department of Defense considers the personal financial stability of service members and their families a significant factor in military preparedness – financial stability equates to mission readiness. As such, financial readiness remains a top priority for the Department of Defense. The Department of Defense is aggressively promoting a culture within the military that values financial competency and responsible financial behavior. The Department of Defense’s *Financial Readiness Campaign* encourages Service members to achieve good credit, save on a regular basis, obtain good interest rates on loans, and take advantage of the opportunity to participate in the Thrift Savings Plan and the Service Members’ and Veterans’ Group Life Insurance.

To assist the military services in delivering financial messages, the Department of Defense established the *Financial Readiness Campaign* in May 2003, which has gathered the support of 24 nonprofit organizations and federal agencies.¹¹⁸ In the past three years, service members have benefited from the educational materials, seminars, and assistance from these agencies. The *Financial Readiness Campaign* includes partnerships with other federal, corporate, and non-governmental organizations to educate both military members and their families on how to manage their finances.

Education is the first line of defense. In 2006, the Department of Defense provided more than 11,800 financial management classes at their installations around the world and trained more than 324,000 service members (approximately 24 percent of the force), as well as 19,400 family members. The campaign's partner organizations, such as those represented by on-installation banks and credit unions, conducted an additional 1,300 classes, serving a total of 60,600 service members and their families.

¹¹⁸ The non-government organizational partners are: American Savings Education Council, American Institute of Certified Public Accounts, Association of Military Banks of America, Consumer Federation of America, Council of Better Business Bureaus, Defense Credit Union Council, Financial Planning Association, InCharge Institute of America, Institute for Consumer Financial Education, Jump\$tart Coalition for Financial Literacy, MoneyWise with Kelvin Boston, National Association of Federal Credit Unions, NASD Foundation, National Endowment for Financial Education, National Military Family Association, Women's Institute for Financial Education and Center for Responsible Lending. Governmental agencies are: Federal Citizen Information Center, Federal Deposits Insurance Corporation, Federal Reserve Board, Federal Trade Commission, Securities and Exchange Commission, U.S. Department of Agriculture Cooperative State Research Education and Extension Service, and U.S. Department of Treasury.

These classes help equip service men and women with the necessary tools to achieve financial freedom and avoid the financial traps that befall many of their contemporaries outside of the military. Other organizational support includes:

- The Financial Literacy and Education Commission provides educational and training materials through the web site www.mymoney.gov. The Financial Literacy and Education Commission also supports a toll-free number and consolidates education and training materials available through the federal agencies that have been widely advertised and linked to the Department of Defense and military service web sites.
- The InCharge Institute provides access to credit counseling/debt management, and publishes a quarterly magazine called *Military Money* in partnership with the National Military Family Association.
- The NASD has funded a multi-year awareness and education program through the Investor Education Foundation's Military Financial Education Campaign ("NASD Foundation") to supplement programs provided by the Department of Defense. Included are multimedia public service announcements through sources such as Armed Forces Radio and Television Services, service command information publications, magazines and radio; an interactive web site – www.saveandinvest.org; sponsorship of a scholarship program for military spouses through partnership with the National Military Families Association to accredit them as 'financial counselors' in return for volunteer hours in military communities; and education for military service financial counselors and educators.
- Military relief societies continue to provide outstanding educational materials and counseling, as well as financial assistance when service members are in need.

The Department of Defense provides free federal and state on-line tax preparation and filing through Military OneSource for all members regardless of component or activation status. This service includes free telephonic access to trained financial professionals who can answer many of the tax questions that our service members and families may have. Department of Defense encourages service members and their families to use the Military OneSource free tax preparation service and to add any refunds to a savings account.

The Department of Defense sponsored "*Military Saves*" Week in February, in conjunction with the Consumer Federation of America's nationwide "*America Saves*" campaign. This is an intense week of training and encouragement for military members and families to start reducing their debt and saving for their future. Members can set a savings goal by registering on www.militarysaves.org.

Predatory Lending: The Department of Defense delivered a report to Congress on the impact of predatory lending practices on members of the Armed Forces and their families. The report showed the Department of Defense is fully engaged in educating service members and their families, and several banks and credit unions on military installations are providing alternative loans along with the Military Aid Societies.

The Department of Defense report stated that service members should consider alternative loans and counseling to resolve their credit problems instead of perpetuating the credit problems through sources with high credit costs. However, the Department of Defense reported there are not adequate methods for controlling the prevalence or the impact of high cost short-term loans.

Legislation in the John Warner National Defense Authorization Act for Fiscal Year 2007 (“National Defense Authorization Act”) concerning predatory lending gave the Department of Defense an opportunity to preclude many of the predatory lending practices from impacting service members and their families. Representatives of the Department of Defense met with members of federal regulatory agencies designated in the National Defense Authorization Act to consult with the Department of Defense, and received input from the trade associations, individual financial institutions and consumer groups concerning the potential impact and unintended consequences associated with the provisions of the National Defense Authorization Act. The Department of Defense has worked with the military services and the federal regulatory agencies to focus the proposed regulation on the provision of the statute that can provide protections for service members and their families, without impacting beneficial forms of credit. In addition to this important policy support, the Department of Defense will continue to educate service members and their families on personal financial matters and work closely with banks and credit unions to develop credit products that can provide beneficial support without the potential for trapping service members and their families in spiraling debt.

State Liaison Initiatives: In 2004, the Department of Defense approached the National Governors Association to request its assistance in supporting those aspects of the quality of life for service members and their families that could be influenced best through the actions of state governments. In the past two years, the Department of Defense has found governors and state legislators have embraced these opportunities to show their support for service members and their families, including limits on payday lending. The federal legislation provides the opportunity to define protections for service members and their families, and the Department of Defense will work with state governments to gain assistance in enforcing proposed regulations in concert with the statutes and policies of the state governments.

3. Continuing Oversight by the SEC and NASD of Broker-Dealers Selling Securities to Military Personnel

Another important regulatory initiative that is already under way is the Commission’s and the NASD’s continuing oversight of broker-dealers’ sales of securities to military personnel. While the Commission has concluded both of the risk-based examination reviews specifically targeting sales to the military community, the Commission’s examiners remain alert to such risks. These risks are typically reviewed in sales office reviews.

In a sales office review, examiners visit a local office of a broker-dealer to evaluate whether the firm's policies and procedures are being followed, whether sales practices violate the anti-fraud provisions of the federal securities laws, and whether the firm is complying with the standards set forth in Commission or NASD rules, or the rules of any other SRO that may be applicable. Sales to military personnel may be implicated in such a review in several ways. The Staff may select a sales office for review because it is located in close proximity to a major military installation. Or, the Staff may select a sales office for review because its business relies on monthly allocations from military salaries. Also, while on-site at a sales office, the examiners may select the accounts of military personnel for detailed review, particularly if they observe potential problems; such as a high early surrender rate for variable insurance products purchased by the office's military customers. Moreover, in sales office and other examinations the examiners remain alert to any indication of problems similar to those identified in the action against American-Amicable.¹¹⁹

In addition, the NASD has adopted examination procedures that address sales of securities to military personnel, the new requirements of the Act, and sales of periodic payment plans. These procedures, when applicable to the firm being examined, are used to determine if the firm and its registered representatives have taken all required steps and made all required disclosures in connection with the sale of securities on military installations. Also, the NASD will review firms to determine whether they have ceased sales of periodic payment plans as directed by the Act. Finally, during routine examinations, the NASD will focus on firm's activities in periodic payment plans. To the extent the firm has conducted business in such products and it is deemed to be an area that warrants review during the examination, the NASD will look at the suitability of sales agents' recommendations to investors who purchased this product, sales practices in connection with plan sales and plan sales literature, and the firm's system for supervising activities relating to this product.

These reviews by the Commission and the NASD will continue. Hence, even though the risk targeted sweeps have been concluded, Commission and NASD examiners will continue to review sales practices directed at the military, as appropriate in individual examinations. They also will remain alert to any indication of abuses similar to those identified in the action against American-Amicable.

4. Investor Education for Uniformed Military Personnel

The Commission has made a significant commitment to investor education for military personnel. Chairman Christopher Cox testified before the Senate Committee on Banking, Housing and Urban Affairs that the Commission is "committed to improving the financial literacy of our service members and their families."¹²⁰ Commissioner Roel Campos said

¹¹⁹ See *supra*, Section VI.A.2.

¹²⁰ Chairman Christopher Cox, *Improving Financial Literacy in the United States*, Testimony Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (May 23, 2006).

that the Commission was focusing its efforts on military personnel, as one of a small number of underserved populations, including, in addition to the military, seniors and teachers.¹²¹ Finally, while on the Commission, former Commissioner Cynthia Glassman noted that as a military wife, some years before, she could have benefited “enormously from knowing the financial facts of life,” and therefore, that she was especially pleased at the commitment to financial education for the military community.¹²² Finally, Commissioner Paul Atkins has conducted investor town hall meetings at a number of military installations, including: Edwards Air Force Base; San Diego Naval Base; Fort Campbell, Kentucky; Marine Corp Recruiting Depot, San Diego; and Camp Pendleton. This commitment has been implemented in major programs both by the Commission, through its Office of Investor Education and Assistance, and the NASD, through its NASD Foundation.)

Through its Office of Investor Education and Assistance, the Commission participates as a charter member in the Department of Defense’s *Financial Readiness Campaign*. That campaign is designed to give service families the opportunity to learn more about personal finances and to encourage them to better manage their money. The effort is directed towards junior enlisted service members and their spouses, because this group is less likely to receive this type of information as part of their formal training. The Office of Investor Education and Assistance supports the efforts of those military personnel stationed at military installations who are responsible for providing financial education to service members. By actively promoting and supporting financial education for military personnel, the Commission is able to assist military investors become better positioned to achieve personal savings and investment goals, including those related to retirement, home ownership, and college education costs.

Additionally, the Commission’s Office of Investor Education and Assistance has conducted workshops at several military installations focusing on providing financial information both to those who are responsible for educating service personnel and to service members themselves. In this regard, it has developed educational materials to help investors understand and make informed decisions regarding their investments. An article dealing with periodic payment plans was published in *Military Money*, a widely distributed free magazine directed at issues involving the finances and lifestyles of military families. Information concerning periodic payment plans and other financial information has been posted on the Commission’s website. Finally, the Commission has enlisted the securities industry itself to identify the military as a risk group that should be given extra compliance attention.

The Commission’s Office of Investor Education and Assistance is a key partner of *SaveAndInvest.org*, a financial education program developed by the NASD Foundation to

¹²¹ Commissioner Roel Campos, *Remarks before the CFP Board Program Directors Conference* (August 3, 2006).

¹²² Commissioner Cynthia A. Glassman, *Remarks before the NASD Investor Education Foundation's Military Financial Education Campaign Launch* (February 16, 2006).

improve the saving and investing knowledge of military service members and their families. The effort is funded by fines levied against First Command for misleading statements in the sales of systematic investment plans to military personnel.

The NASD reports that the multifaceted “*SaveAndInvest.org*” program includes:

- ✓ Partnerships with other organizations, including the Department of Defense, whose expertise in the financial education arena and experience in addressing military audiences complement the NASD Foundation's commitment to providing financial education information and resources to service members and their families;
- ✓ An online resource center, www.SaveAndInvest.org, that serves as a centralized, trusted source for unbiased information on saving and investing, including original content, interactive tools and games, partner resources, frequently asked questions, and more;
- ✓ On-the-ground training to support the military's current Personal Financial Management program by establishing a coordinated and uniform financial education program, including the training and continuous certification of personal financial counselors and other volunteers;
- ✓ A spousal fellowship program that will train a corps of military spouses to provide financial counseling and education within the military community;
- ✓ Educational toolkits for trainers and investors offering multiple levels of personal financial information;
- ✓ Educational activities and events on or near military bases to motivate military families to take responsibility for their financial well-being; and
- ✓ A long-term public outreach campaign, including print, radio and television public service announcements, targeted advertising to military-serving newspapers, magazines and Web sites and outreach to raise awareness of the tools, information and services available to military personnel and their families.

The NASD states through the NASD Foundation’s Military Financial Education Campaign, it is actively committed to providing investor education to the military and has made great strides towards helping military service members and their families learn how to manage their money with confidence. The NASD Foundation’s campaign was launched at the United States Capitol on February 16, 2006, with speeches by Senator Daniel Akaka (D-HI), Senator Hillary Rodham Clinton (D-NY), Congressman Michael Oxley (R-OH), and Under Secretary of Defense for Personnel and Readiness David S.C. Chu. To date the NASD states the NASD Foundation’s most significant accomplishments included:

- ✓ Financial Forums reached more than 4,500 members of the military community during *25 Military Financial Education Forums* at 19 military duty stations worldwide, including at sea onboard the USS Ronald Reagan in the Arabian Gulf war zone. These events cover the basics of saving and investing, avoiding the predatory loan trap, investing in mutual funds, and planning for retirement. In addition to high marks on attendee evaluations, the NASD has received three letters of commendation for our forum presentations from flag officers and commanders.
- ✓ The Spouse Outreach campaign created and presented the unique *Military Spouse Fellowship Program* to help military spouses earn the Accredited Financial CounselorSM credential. More than 2,800 candidates applied for this highly competitive educational opportunity. Currently, 174 fellows are actively engaged, four have been hired within the military system, and many others have already begun providing volunteer counseling services to their communities. Notably, an August 2006 survey of program participants showed that 82% have changed their own saving and investing habits since joining the program.
- ✓ Train-the-Trainer Materials have been crafted and delivered, including the “It’s Your Move” continuing financial education program for military Personal Financial Managers. The program has been successfully complete by 268 Personal Financial Managers, representing all of the services. Reaction to the program has been overwhelmingly positive, with 82% of the 199 who submitted training session evaluations feeling equipped to teach the course themselves.
- ✓ Relocation resources have been provided by producing and distributing more than 300,000 copies of “*Military Families: Money and Mobility*,” which provides comprehensive information and checklists for military families preparing for moves and deployments.
- ✓ The Foundation also worked with the Commission’s Office of Investor Education and Assistance to produce *SaveAndInvest.org*. As discussed above, this new online resource center at *SaveAndInvest.org* provides unbiased, noncommercial information on saving and investing specifically tailored for service members and their families. The interactive site includes original content, content from 11 government and non-profit partners, interactive tools, links to financial education resources, frequently asked questions, and more.

Throughout 2007, the Commission’s Office of Investor Education and Assistance and the NASD will continue to provide military families with the tools and resources they need to save and invest with confidence. New events include military forums at Fort Gordon Marine Corps Air Station Yuma, San Diego Marine Corps Recruit Depot, Camp Pendleton, Marine Corps Air Station Miramar, and Marine Corps Air Ground Combat Center 29 Palms, with more than 1,600 officers, enlisted personnel, and spouses attending. The NASD’s additional activities underway include plans to launch an e-learning financial simulation game for young service members and their families and a pilot program that will provide an innovative

credit management tool that helps military families understand and improve their credit scores.

B. The Commission has No Further Recommendations at this Time

In light of the legislative and regulatory initiatives already in place, and after consultations with the Department of Defense, the Commission has no further legislative or regulatory recommendations to make at this time. As discussed above, by prohibiting sales of periodic payment plans Congress already has addressed the single leading problem identified by the Commission and its staff in sales of securities to military personnel. Moreover, the on-going initiatives of the Department of Defense; the Commission's and NASD's continuing oversight of broker-dealers that sell securities to military personnel, including the Commission's and NASD's continuing alertness to abuses similar to those identified in the action against American-Amicable, and the Commission's and NASD's active program of investor education for uniformed military personnel are already underway and should play significant roles in further protecting our uniformed military personnel. The Commission believes the most appropriate action at this time is to allow those initiatives to carry forward. All have already achieved considerable success. As a result, the Commission has no further legislative or regulatory recommendations at this time.

VIII. CONCLUSION

The Commission strongly believes that our servicemen and women must be protected from illegal and abusive practices in the sale of securities. The Commission has undertaken a comprehensive program to address such practices targeting military personnel. Our program includes enforcement activity, examination activity, close coordination with Department of Defense and the NASD, and investor education and other outreach activity. The problems associated with periodic payment plans are no longer a significant issue because of the statutory prohibition. We expect to address other problems as they arise through our continuing oversight of potentially abusive activities. We look forward to continuing to work closely with these Committees, the Department of Defense, the NASD, and other regulators to protect members of the military as investors in our markets.