



Risk Management Update December 2007

APPROACHING THE HEIGHTENED STANDARDS IN OFFERING INVESTMENT TOOLS TO SERVICE MEMBERS

With the Military Personnel Financial Services Protection Act of 2006 (“the Act”), Congress has shown a heightened interest in protecting members of the military from predatory and dishonest offerings of securities and insurance products. The Act was promulgated in response to broker-dealers selling inappropriate life insurance policies to young and vulnerable military personnel. Such personnel often have young families and are naturally fearful of the financial consequences of what might happen to their families should the military member die in combat.

During Operation Iraqi Freedom, certain broker-dealer advisers began exploiting these fears, selling military members products such as life insurance policies that would become payable to beneficiaries should the member die in combat. As an added bonus, the insurance company also would “invest” part of each monthly “premium,” ostensibly for the benefit of the military member. However, hidden within the policy, the insurance company was permitted to use the invested amount to create a fund from which the insurance company could draw monies should the soldier fail to make a premium payment.

Often if the military member returned home safely from a tour of duty, he or she would decide to no longer continue the life insurance policy. However, instead of cancelling the policy, the member would stop paying the insurance premiums. Such actions would trigger the insurance company to rely on the terms of the policy and draw from the military member’s investment fund to keep the policy alive. Consequently, once the military member’s investment fund was exhausted, only then would the insurance company automatically cancel the insurance policy.

Unfortunately, these products were often sold to military members who did not know that the armed services provided its own, more suitable, life insurance policies by way of Service Members’ Group Life Insurance.

As a result of the Act, a series of standards must now be followed when selling securities and insurance products to military personnel. These requirements include, among other things:

- A prohibition on the sale of periodic payment plans (which are defined in the Investment Company Act as any mechanism that invests a portion of a periodic payment into a mutual fund);
- A declaration that any state law, regulation or order related to insurance sales applies to activities conducted on military installations;

- A requirement for broker-dealers to inform military personnel about life insurance available through the federal government;
- The establishment of a list of barred brokers and agents that must be made available to installation commanders, as well as state and federal regulators;
- A requirement that broker-dealers provide certain investors with access to information about the broker-dealer including disciplinary actions;
- A prohibition on the sale of any life insurance product to any member of the Armed Forces or dependant on a military installation, unless specified written disclosures have been provided at the time of the sale;
- The voiding of any life insurance product in violation of the Act from its inception, at the sole option of the member of the Armed Forces or their dependant; and
- The prohibition of any person who has intentionally violated, or willfully disregarded, these requirements from further engaging in the business of insurance with respect to federal employees on federal land, except regarding existing policies.^[1]

Tips for Investment Advisers and Broker-Dealers to Ensure Compliance with the Act

Based on the Act, investment advisers and broker-dealers should consider the following risk management tips whenever dealing with military personnel.

1. Disclosure, Disclosure, Disclosure! Along with the normal disclosures required for retail investors, there are additional disclosures required when dealing with military personnel. If you sell insurance products to military personnel, be sure to disclose all material components of the policy and inform the client of all risks associated with their investment decision. Also, inform the client that military life insurance policies are available to them. If you do not make the proper disclosures, the client can rescind the contract without penalty.
2. Check to see if the proposed investment tool fits the definition of a periodic payment plan. If you sell *any* investment tool to military personnel which fits this definition, you may be in direct violation of the Act. This rule is not limited to insurance products.
3. Ensure familiarity with the various state laws pertaining to the regulation of insurance sales. Just because you are selling to a member of the military does not make you unsusceptible to state law. Furthermore, it is advisable to inform your potential military clients of the material aspects of the state laws which govern their policy.
4. Training. Be sure to train and inform your employees about their additional legal obligations to military personnel. Keep your staff up to date on the policies and procedures that surround sales to members of the military.
5. Education. Congress has expressed an interest in educating military personnel and their dependents on personal finance and securities. Whilst this is not a requirement of the Act, education assists clients in deciding for themselves which

^[1] Novak, Diane P. "Offering Securities and Insurance Products to Military Personnel." NSCP Currents September/October issue 2007.

financial products are best for their personal goals and objectives. A good place to direct your military clientele (and employees) for additional information is www.saveandinvest.org.

Core Compliance & Legal Services, Inc. wishes you and yours a very Happy Holiday Season!

Michelle L. Jacko, Esq., CEO of Core Compliance & Legal Services, Inc. (“CCLS”) and Managing Partner of Jacko Law Group, PC. CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

This article is for information purposes and does not contain or convey legal or tax advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer and/or tax professional.