

HOUSE BILL REPORT

SSB 6295

As Passed House:
February 27, 2012

Title: An act relating to exchange facilitator requirements.

Brief Description: Modifying certain exchange facilitator requirements and penalties.

Sponsors: Senate Committee on Financial Institutions, Housing & Insurance (originally sponsored by Senator Morton).

Brief History:

Committee Activity:

Business & Financial Services: 2/16/12 [DP].

Floor Activity:

Passed House: 2/27/12, 97-0.

Brief Summary of Substitute Bill

- Modifies provisions regarding fidelity bonds required for an exchange facilitator.
- Requires an exchange facilitator and their client to independently authenticate a withdrawal from a qualified escrow account or qualified trust.
- Requires additional disclosures.
- Expands criminal penalties to include an exchange facilitator who fails to comply with the requirements regarding a fidelity bond, disclosure provisions, or withdrawal of funds.

HOUSE COMMITTEE ON BUSINESS & FINANCIAL SERVICES

Majority Report: Do pass. Signed by 12 members: Representatives Kirby, Chair; Kelley, Vice Chair; Bailey, Ranking Minority Member; Buys, Assistant Ranking Minority Member; Blake, Condotta, Hudgins, Hurst, Kretz, Pedersen, Rivers and Ryu.

Staff: Jon Hedegard (786-7127).

Background:

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

The Internal Revenue Code (26 U.S.C. 1031) (Code) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business, or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more "like-kind" replacement properties.

This enables a property owner to defer the payment of federal income taxes on the transaction. If the replacement property is sold (as opposed to making another qualified exchange), the property owner must pay tax on the original deferred gain plus any additional gain realized since the purchase of the replacement property. Section 1031 of the Code does not apply to exchanges of inventory, stocks, bonds, notes, other securities or evidence of indebtedness, or certain other assets.

There are Code provisions regarding the exchange process. The 1031 exchanges require the assistance of an exchange facilitator (facilitator) or qualified intermediary. The facilitator holds proceeds from the sale of the original property until those funds are applied to the purchase of the replacement property. While in the possession of the facilitator, funds may be deposited in a financial institution or placed in another investment. If these provisions are not met, the exchange does not qualify to defer the taxation.

State Regulation of Facilitators.

In 2009 the Governor signed legislation that established a regulatory framework for a person that is a facilitator. Facilitators are not directly regulated by a state agency. There are a number of provisions related to facilitators.

Financial Security – Fidelity Bond.

Each facilitator must:

- maintain a fidelity bond or bonds in an amount of not less than \$1 million; or
- deposit an amount of cash and securities or irrevocable letters of credit equivalent to \$1 million into an interest-bearing deposit or money market account at a financial institution of the facilitator's choice. The interest accrues to the facilitator.

Compliance with Financial Security Requirements and Claims Against the Financial Security.

A facilitator must demonstrate compliance with the fidelity bond and other insurance requirements upon the request of a current or prospective client. Any person claiming to have sustained damage by reason of the failure of a facilitator to comply with this chapter may seek to recover damages from the facilitator's insurance, fidelity bond or bonds or the deposits, or the letters of credit maintained in lieu of the insurance, bond, or bonds.

Custodian of Funds.

A facilitator must act as a custodian for all exchange funds, property, and other items received from the client. The exchange funds must be held in a manner that provides liquidity and preserves principal. A facilitator must provide the client with written notification of how the funds are invested or deposited. If invested, the facilitator must invest the exchange funds in investments that meet a prudent investor standard and that satisfy the goals of liquidity and preservation of principal. A prudent investor standard is violated if any of a number of standards are violated.

Prohibited Practices.

A facilitator must not, knowingly or with criminal negligence, commit specified prohibited practices related to a like-kind transaction. These prohibited practices include:

- making false, deceptive, or misleading material statements;
- making deceptive or misleading material statements in advertising;
- engaging in unfair or deceptive acts;
- commingling of funds, except as allowed;
- loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping exchange funds under a client's name;
- material failure to fulfill contractual duties to deliver funds or property unless the failure is due to a cause that is beyond the control of the facilitator;
- failure to provide required disclosures;
- negligently making a false statement or willfully omitting a material fact in a report or investigation; and
- committing certain crimes.

Criminal Penalties.

It is a class B felony to commit certain prohibited practices related to a like-kind transaction. These prohibited practices include:

- making false, deceptive, or misleading material statements;
- making deceptive or misleading material statements in advertising;
- engaging in unfair or deceptive acts;
- commingling of funds, except as allowed;
- loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping exchange funds under a client's name; and
- material failure to fulfill contractual duties to deliver funds or property unless the failure is due to a cause that is beyond the control of the facilitator.

It is a misdemeanor to commit certain prohibited practices related to a like-kind transaction. These prohibited practices include:

- failing to make disclosures required by any applicable state or federal law; or
- negligently making any false statement or knowingly and willfully making any omission of material fact in connection with any reports filed by a facilitator or in connection with any investigation conducted by the Department of Financial Institutions.

Consumer Protection Act.

Violations of the chapter are violations under the Consumer Protection Act.

Summary of Bill:

An intent section makes a number of findings regarding exchange facilitators.

Financial Security – Fidelity Bond.

The fidelity bond must be maintained for the benefit of a client of the facilitator that suffers a loss as a result of the facilitator's covered dishonest act. The fidelity bond must cover the acts of employees of a facilitator and any owners of a non-publicly traded facilitator.

Cash or irrevocable letters of credit are no longer allowed as an option instead of a fidelity bond.

Qualified Escrow Accounts and Qualified Trusts.

A qualified escrow account or qualified trust must provide that a withdrawal from that escrow account or trust requires the facilitator and the client to independently authenticate a record of the transaction.

Disclosure.

A facilitator must include a specific disclosure statement on the facilitator's website and in contracts. If recommending other products or services, the facilitator must disclose to the client that the facilitator may receive a financial benefit as a result of the recommendation. The facilitator must not recommend or suggest to a client the use of services of another organization or business entity in which the facilitator has a direct or indirect interest without full disclosure of the interest.

Penalties – Civil and Criminal.

Failure to fulfill the bond and disclosure requirements is prima facie evidence that the facilitator intended to defraud a client who suffered a subsequent loss of the asset entrusted to the facilitator.

The list of class B felonies is expanded to include a person who fails to comply with the fidelity bond, disclosure, or withdrawal requirements. However, a facilitator is not guilty of a class B felony for failure to comply with the fidelity bond requirements if:

- the failure to comply is due to an action by the bond issuer; and
- the facilitator: (1) takes all reasonable steps to comply with the statutory requirements within 30 days; and (2) deposits any new exchange funds into a qualified escrow account or qualified trust until a fidelity bond that meets statutory requirements is obtained.

Damages awarded in a civil suit filed for a violation of the financial security requirements include treble damages and attorneys' fees.

Task Force.

A task force is established to identify effective regulatory procedures for the 1031 exchange facilitator industry. The task force includes the Department of Financial Institutions, the Office of the Insurance Commissioner, facilitators, and title holders. Issues for discussion must include, but not be limited to:

- the feasibility and cost of regulation;
- regulatory and enforcement standards;
- certification or licensing options; and
- the feasibility of adopting provisions within the Escrow Agency Act.

Specific recommendations on these issues are due to the Legislature by December 1, 2012.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.

Staff Summary of Public Testimony:

(In support) This is an extremely important bill. It addresses a serious problem. There needs to be state or federal legislation that ensures adequate consumer protections regarding exchanges and facilitators. People in this state have lost their life savings due to the acts of a facilitator. The federal government requires the use of a facilitator to hold the money. There are about 10 facilitators in the state. One of the facilitators has stolen the money that was entrusted to him by a number of clients. That facilitator was bonded and insured under the existing law. There is no coverage under the insurance or the bond for the acts of that facilitator because he was the owner of the company. The money that was stolen may never be returned to the victims. This bill may help prevent this type of crime against other people.

(Opposed) None.

Persons Testifying: Senator Morton, prime sponsor; and Howard Asmussen.

Persons Signed In To Testify But Not Testifying: None.