
Business & Financial Services Committee

ESSB 5082

Brief Description: Concerning exchange facilitator requirements.

Sponsors: Senate Committee on Financial Institutions, Housing & Insurance (originally sponsored by Senators Benton and Smith).

Brief Summary of Engrossed Substitute Bill

- Modifies provisions of the exchange facilitator law related to deposit of client funds, claims on a fidelity bond, disclosures, custodial duties, prohibited practices, and criminal penalties.

Hearing Date: 3/5/13

Staff: Alexa Silver (786-7190).

Background:

Section 1031 of the Internal Revenue Code provides that no gain or loss is recognized on the exchange of business or investment property for business or investment property of a like kind. A tax-deferred exchange is a method by which a property owner trades relinquished property for like-kind replacement property and defers payment of federal income taxes on the transaction. A tax-deferred exchange may be made using an exchange facilitator. The exchange facilitator holds the proceeds from the sale of the original property until the funds are applied to the purchase of the replacement property.

Washington law imposes requirements on exchange facilitators and prohibits exchange facilitators from engaging in certain practices.

Fidelity Bond and Deposit of Funds. An exchange facilitator must either:

- maintain a fidelity bond of at least \$1 million for the benefit of a client who suffers a loss as a result of the exchange facilitator's "covered dishonest act"; or

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.

- deposit all exchange funds in a qualified escrow account or qualified trust with a financial institution. The qualified escrow account or qualified trust must provide that a withdrawal requires the exchange facilitator and the client to independently authenticate a record of the transaction.

These requirements must be disclosed on an exchange facilitator's website and in agreements with clients. A person who sustains damages because of the exchange facilitator's fraudulent or dishonest acts may file a claim on the fidelity bond.

Custodian of Funds. An exchange facilitator acts 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, and the client is entitled to written notification of how the funds are invested or deposited. For funds that are invested, the exchange facilitator's investments must meet a prudent investor standard and satisfy the goals of liquidity and preservation of principal. Transactions that violate the prudent investor standard are enumerated in statute.

For accounts with a value of \$500,000 or more, the exchange facilitator must deposit client funds in a separately identified account, and the client must receive all earnings credited to the account. For accounts with a value of less than \$500,000, the exchange facilitator may deposit client funds in a pooled interest-bearing account with the client's consent.

Prohibited Practices. A facilitator must not, knowingly or with criminal negligence, commit specified prohibited practices related to a like-kind transaction. For example, an exchange facilitator must not fail to fulfill its contractual duties to deliver funds or property to the taxpayer "in a material way," unless that failure is due to a cause beyond the exchange facilitator's control.

Civil and Criminal Penalties. An exchange facilitator who commits any of the following prohibited acts is guilty of a class B felony:

- making false, deceptive, or misleading material representations concerning a like-kind transaction, including in advertising;
- engaging in unfair or deceptive practices toward a person;
- obtaining property by fraud or misrepresentation;
- failing to account for money or property belonging to others that may be in the possession of or under the control of the exchange facilitator;
- commingling funds or loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping money in a financial institution under the client's name, unless the money belongs to the client and was entrusted to the exchange facilitator by the client;
- failing to maintain the fidelity bond or deposit exchange funds in a qualified escrow account or qualified trust; and
- failing to make required disclosures.

Committing certain other prohibited practices is a misdemeanor. Violation of the exchange facilitator law is a per se violation of the Consumer Protection Act.

Stakeholder task force. Substitute Senate Bill 6295, enacted in 2012, convened a stakeholder task force to identify effective regulatory procedures for the exchange facilitator industry. The

issues for discussion included the feasibility and cost of regulation, regulatory and enforcement standards, certification or licensing options, and the feasibility of adopting provisions in the escrow agency law.

Summary of Bill:

Fidelity Bond and Deposit of Funds. The fidelity bond is for the benefit of a client who suffers a direct financial loss (rather than a loss) as a result of the exchange facilitator's covered dishonest acts. "Covered dishonest acts" are defined to mean crimes involving fraud, embezzlement, misappropriation of funds, robbery, and other theft of property.

For a qualified escrow account or qualified trust, the exchange facilitator must provide that a withdrawal of exchange funds requires independent authentication. In addition, an exchange facilitator must provide for the client to receive independently from the financial institution a current statement for verification of the deposited exchange funds. "Financial institution" is defined to include financial institutions chartered in any state, not just Washington.

The disclosure to the client must: include additional information about the qualified escrow account or qualified trust; note that exchange facilitation services are not regulated by a state or federal agency; and state that it is the client's responsibility to determine that the funds will be held in a safe manner.

Custodian of Funds. An exchange facilitator must hold and invest a client's funds in a manner that preserves any earned interest, in addition to principal. Regardless of the value of the client's account, client funds must be deposited in a separately identified account, rather than a pooled interest bearing trust account.

Prohibited Practices. The qualification that certain practices are prohibited if committed "knowingly or with criminal negligence" is eliminated. The prohibited practice related to failing to deliver property or funds to the taxpayer is modified. An exchange facilitator must not fail to deliver property or funds in a material way, unless: (1) the failure was due to insufficient liquidity or loss of principal due to events beyond the prediction or control of the exchange facilitator; or (2) the investment was specifically requested by the client.

Criminal Penalties. An exchange facilitator commits a class B felony only if the violation was a knowing violation. Failing to fulfill contractual duties to deliver funds or property "in a material way" also constitutes a class B felony.

Appropriation: None.

Fiscal Note: Available.

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