SENATE BILL REPORT
ESSB 5082

As Passed Senate, February 15, 2013

Title: An act relating to exchange facilitator requirements.

Brief Description: Concerning exchange facilitator requirements.

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

Brief History:
Committee Activity: Financial Institutions, Housing & Insurance: 1/22/13, 1/29/13 [DPS].
Passed Senate: 2/15/13, 47-0.

SENATE COMMITTEE ON FINANCIAL INSTITUTIONS, HOUSING & INSURANCE

Majority Report: That Substitute Senate Bill No. 5082 be substituted therefor, and the substitute bill do pass.

Signed by Senators Hobbs, Chair; Mullet, Vice Chair; Benton, Ranking Member; Fain, Hatfield, Nelson and Roach.

Staff: Edward Redmond (786-7471)

Background: 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.

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.

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.

In 2009 the Legislature passed E2SHB 1078 (Chapter 70, Laws of 2009) to regulate the activities of facilitators, which was in response to their recent investment activities which resulted in significant asset losses to clients. Amongst other obligations, the Legislature required a facilitator to maintain a $1 million dollar fidelity bond or deposit an equivalent amount of cash and securities into an interest-bearing or money market account; demonstrate compliance with the fidelity bond and insurance requirements if requested by a current or prospective client; and act as a custodian for all exchange funds, property, and other items received from the client. The Legislature also held a facilitator criminally and civilly liable for engaging in certain prohibited practices such as making false or misleading material statements; commingling of funds, except as allowed; and failing to make disclosures required by any applicable state or federal law.

Facilitators were required to submit a report on their activities to the Department of Financial Institutions (DFI) at the end of 2009, which was later submitted in a report to the Legislature by DFI.

In 2012 the Legislature passed SSB 6295 (Chapter 34, Laws of 2012) in response to white collar criminal activity by a facilitator in the local facilitator industry, resulting in over $800,000 financial loss to residents of this state.

SSB 6295 (Chapter 34, Laws of 2012) provided that a person engaged in the facilitator business must either maintain a fidelity bond for at least $1 million dollars which covers the dishonest acts of employees and owners, or deposit all exchange funds in a qualified escrow account or qualified trust. The qualified escrow account or qualified trust must require the facilitator and the client to independently authenticate a record of any withdrawal or transfer from the account. Facilitators must provide a disclosure statement on the company website and in the contractual agreement regarding the fidelity bond and qualified escrow account or trust. Additionally, facilitators must disclose any financial benefits they may receive for recommending other products or services to clients. Failure to comply with the requirements of the new law is prima facie evidence that the facilitator intended to defraud a client who suffered a subsequent loss of assets entrusted to the facilitator. With limited exceptions, a facilitator is guilty of a class B felony for noncompliance. A current client of a facilitator may receive treble damages and attorneys' fees as part of the damages awarded in a civil suit against the facilitator for violation of these requirements.

SSB 6295 (Chapter 34, Laws of 2012) also required a stakeholder taskforce, comprised of DFI, the Office of Insurance Commissioner, facilitators, and title holders, to convene over the interim to identify effective regulatory procedures for the facilitator industry and provide specific recommendations to the Legislature by December 1, 2012. The stakeholder taskforce met for two hours on three separate occasions over the interim. Key recommendations for improvement were identified, negotiated, and incorporated into draft legislation, and a report of the taskforce interim activities was prepared. Provisions concerning what is covered under a fidelity bond is an unsettled issue for the facilitator industry.

Summary of Engrossed Substitute Bill: A person engaged in the facilitator business must provide the client with a disclosure document prior to any contractual agreement between the parties and post on their website a disclosure notice which explicitly states that facilitator

services are not regulated by any state agency. The facilitator must deposit client funds into a separately identifiable account. The client must receive independent access to the current account statement from the financial institution in order to verify that the exchange funds have been deposited by the facilitator. The facilitator must return to the client all earnings credited to the separately identified account.

A new definition is added to the exchange facilitator statute. Covered dishonest acts is defined as crimes involving fraud, embezzlement, misappropriation of funds, robbery, or other theft of property. Exchange facilitators must maintain a fidelity bond for the benefit of the client that suffers a direct financial loss as a result of the exchange facilitator's covered dishonest acts.

The chartering requirements of a bank, credit union, savings and loan association, savings bank, or trust company, for purposes of this statute, are amended. The definition of financial institution includes entities charted under the laws of any state within the United States.

The criminal intent of – knowingly or with criminal negligence – referenced under RCW 19.310.100 is moved to RCW 19.310.120; however, the required intent is not modified.

Appropriation: None.

Fiscal Note: Available.

Committee/Commission/Task Force Created: No.

Effective Date: Ninety days after adjournment of session in which bill is passed.

Staff Summary of Public Testimony on Original Bill: PRO: Senator Morton's close friends and constituents were the victims of theft from an exchange facilitator. Section 1031 exchanges are a great program. The reason why they work is because those that utilize the program are confident that the agent they entrust with their money is in fact trustworthy. If a client has even a moment's pause that their money may not be there when they return, it would bring the entire program into question. This bill is before the committee because we feel it is important to protect citizens whenever they are allowing a third party to handle what could be their life savings. There must be proper protections in place to protect citizens from losing their money. This bill will enhance and improve the institution rather than detract from it.

CON: The taskforce members met over the interim and did commendable work on the bill. The bill is excellent except for the provisions concerning what must be covered under a fidelity bond. Fidelity bonds are to protect against theft of client funds. The language in the bill is more broad and includes false advertising, misrepresentation, and unfair trade practices. The broad coverage required for bonds in the bill is commercially unavailable to facilitator companies. The fidelity bond option is important because it provides smaller clients with an alternative to the trust account which generally is a more expensive option. If the issues concerning the fidelity bond coverage were addressed, then there would be no further opposition to the bill.

Persons Testifying: PRO: Senator Benton, prime sponsor; Senator Smith.

CON: Mary Foster, 1031 Services, Inc.; Toija Beutler, Investment Property Exchange Services, Inc.