
Business & Financial Services Committee

HB 2916

Brief Description: Concerning exchange facilitators.

Sponsors: Representative Ryu.

Brief Summary of Bill

- Creates licensure requirements for exchange facilitators.
- Creates bonding and insurance requirements for exchange facilitators.
- Imposes penalties for noncompliance.
- Grants rulemaking and administrative enforcement authority to the Department of Financial Institutions.
- Requires an annual assessment from licensees.

Hearing Date: 2/3/16

Staff: David Rubenstein (786-7153)

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, Insurance, and Deposit of Funds.

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.

An exchange facilitator must either:

- maintain a fidelity bond of at least \$1 million for the benefit of a client who suffers a direct financial loss as a result of the exchange facilitator's "covered dishonest act"; or
- deposit all exchange funds in a qualified escrow account or qualified trust, as defined in the Internal Revenue Code, with a financial institution. The qualified escrow or trust account must provide that a withdrawal requires the exchange facilitator and the client to independently authenticate a record of the transaction and the client must receive independent statements from the financial institution.

A "covered dishonest act" is a crime involving fraud, embezzlement, misappropriation of funds, robbery, or other theft of property. A person who sustains damages because of the exchange facilitator's fraudulent or dishonest acts may file a claim on the fidelity bond.

The exchange facilitator must also either maintain an errors & omissions insurance policy of at least \$250,000 or deposit cash, securities, or irrevocable letters of credit in the same amount at a financial institution.

Website Disclosure.

The exchange facilitator must post a disclosure on the facilitators website. The disclosure must state the alternative fidelity bond and qualified escrow or trust account requirements and the additional safeguards applicable to qualified escrow and trust accounts. It must also state that exchange facilitators are not regulated by any agency of the State of Washington or the federal government and that it is the client's responsibility to determine that exchange funds will be held in a safe manner.

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. The exchange facilitator must deposit all client funds in a separately identified account, and the client must receive all earnings credited to the account.

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 account.

Prohibited Practices.

A facilitator must not 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 knowingly 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;
- fail to deliver property or funds in a material way, unless the failure was due to events beyond the prediction or control of the exchange facilitator or an investment specifically requested by the client;
- 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.

Failing to make required disclosures and making false statements to the Department of Financial Institutions 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. Some of the recommendations of the task force were enacted into law in 2013 with Engrossed Substitute Senate Bill 5082.

Summary of Bill:

License Required.

A new licensing framework is created for exchange facilitators. No person may engage in the business of an exchange facilitator without first becoming licensed by the Department of Financial Institutions (Department). If not licensed and fully in compliance with the chapter, an exchange facilitator may not sue for compensation from clients and is subject to administrative penalties, including fines and removal from office.

Two kinds of licenses are created: an exchange facilitator company license and an exchange facilitator officer license. No person may act as an exchange facilitator unless employed by a licensed exchange facilitator company (LEFC). Every LEFC must employ at least one licensed exchange facilitator officer (LEFO), but not every exchange facilitator employee must be licensed.

Banks and other financial institutions are exempt from licensure.

Designated Exchange Facilitator Officers.

Every LEFC must designate one LEFO as the designated exchange facilitator officer (DEFO). The DEFO must be a partner or officer of the LEFC and must oversee exchange facilitation transactions, the management of the LEFC's trust account, and supervise the conduct of employees and agents of the LEFC. The DEFO, principal, or officer supervising an employee or independent contractor is responsible for violations committed by the LEFC.

The LEFC may change its designated officer at any time.

License Applications.

Exchange Facilitator Companies.

An exchange facilitator company license applicant must provide to the Department:

- the company's basic information;
- the names of officers, directors, and partners;
- the officer that the company designates as its DEFO;
- identifying information and fingerprints for each officer, director, and owner for a background check;
- information relating to each officer's, director's, and owner's experience, business record, purposes, personal history, and other pertinent facts required by the Department;
- other information required by the Department;
- proof of a required fidelity bond; and
- an investigation fee and a license fee set by the Department.

A licensed company may have multiple branches, but each branch must be licensed separately and each must have its own DEFO.

Exchange Facilitator Officers.

An exchange facilitator officer license applicant must either be a licensed attorney or certified public accountant or have been a full-time exchange facilitator for the previous three years. The applicant must take an examination developed or approved by the Department and, within one year of passing the examination, must provide to the Department:

- an application endorsed by the LEFC employing the officer;
- proof, as determined by the Department, of the officer's honesty, good reputation, and identity; and
- a fee set by the Department.

The license must be issued if the applicant:

- meets all the requirements;

- has not had a license suspended or revoked in any state in the past five years
- has not been convicted of a felony, gross misdemeanor involving dishonesty, or a violation of banking laws in the last seven years; and
- has satisfactory financial responsibility, experience, character and general fitness.

Both applications must be made through a nationwide electronic license tracking system (NMLS). The Department may waive one or more of the license application requirements. Each license must be renewed annually, and lapsed licenses may be reinstated within 60 days.

Change in Information or Condition.

In the event any material information from the licensee's application changes, the licensee must notify the Department of the change within 10 business days and pay the applicable fee. The licensee must also notify the Department within one business day of its bankruptcy, receivership, dissolution, revocation of a license in another state, cancellation of a bond, or a felony charge or conviction of an officer.

Surrender.

A licensee may surrender a license with written notice to the Director but such surrender does not affect the licensee's civil or criminal liability for acts committed under the license or the licensee's obligations in contract.

Annual Assessment.

A LEFC must pay an annual assessment to the Department for any year in which it had a license. A license expires for failure to pay the annual assessment results.

Bonds, Insurance, and Assurances of Good Conduct.

A LEFC may not employ a person to handle exchange transactions who has been convicted of a felony or gross misdemeanor involving dishonesty in the previous seven years, nor employ a person who handles client funds if the person has shown a disregard in the management of his or her own financial condition in the previous three years.

Fidelity Bond or Separate Deposit Accounts.

The fidelity bond and qualified trust or escrow account requirement is modified such that both are required, rather than alternatives. Each LEFC must obtain a fidelity bond of at least \$1 million covering the acts of any employee or agent (rather than only employees) and the bond must have a deductible not greater than \$10,000. In addition, each LEFC must also use a qualified trust or escrow account that requires signatures of both the facilitator and the client for any withdrawal and independent statements provided to the client.

Surety Bond.

A surety bond requirement is added. If the fidelity bond has a deductible, the company must also maintain a surety bond of at least \$10,000. The bond must run to the benefit of the state and any person injured by the company's violations.

Errors & Omissions Policy.

Finally, each LEFC must maintain an errors and omissions insurance policy (E&O policy) of at least \$250,000. The option to deposit funds, securities, or letters of credit in the same amount is eliminated. The LEFC must disclose the amount of the E&O policy.

The fidelity bond, surety bond, and E&O policy must be kept in effect as a condition precedent to the exchange facilitator's authority to handle exchange transactions in Washington. An LEFC must provide proof of bonding and insurance when requested. If the fidelity bond is canceled, the Department may order a new bond be filed or the company's license may be revoked.

Records & Reporting.

Each licensee must keep books and records sufficient to enable the Department to determine the licensee's compliance or noncompliance. The Department must have free access to such records and each licensee must maintain the records for three years after the conclusion of each transaction. The licensee must report information required by rule to the Department annually. Failure to report may result in a fine of \$50 per day.

False Advertising.

Licensees are prohibited from publishing any false, deceptive, or misleading advertising.

Privacy and Confidentiality.

Federal or state laws protecting the privacy or confidentiality of information provided to the Department continue to apply after disclosure to the Department. Additionally, the Department may enter information sharing arrangements with other government entities and provide such information to those agencies loss of privilege or confidentiality and is not subject to disclosure, subpoena, or discovery.

Website Disclosure.

The required website disclosure is amended to reflect changes to the bond and escrow or trust account provisions and the fact that exchange facilitators are regulated by the state.

Rulemaking and Enforcement.

Generally.

The Director and the Department have broad administrative discretion to administer and interpret the chapter governing exchange facilitators, including rulemaking authority to implement the act by January 1, 2017. If the Department determines that a licensee is conducting business in a manner that violates the chapter, it may order the discontinuation of the conduct and may obtain a court injunction against the continuation of the violation.

License Penalties.

The Department is tasked with enforcing the chapter governing exchange facilitators. The Department may deny an application for a license for failure to meet the requirements for licensing violating a departmental order, revocation of a license in another state, or filing of an incomplete application. The Department may condition, suspend, or revoke a license for failure

to pay a fee or maintain a bond, knowing or reckless violations of the chapter, or an ineligibility for licensure.

Fines, Orders, and Subpoenas.

The Department has the authority to take administrative actions and hold hearings to enforce the chapter. Failure to appear at a hearing is deemed consent to the hearing. The Department may impose fines of up to \$100 per day for a violation of the chapter or failure to comply with a departmental order and is empowered with other administrative enforcement authority, including restitution, refund and cease and desist orders. Finally, the director may remove from office persons involved in the company and may obtain a court order giving the director subpoena authority.

Investigation.

The Department may investigate or examine the books and records of any licensee and must have free access to the licensee's employees, offices, and files. The investigation may require testimony under oath and the production of documents. Investigations must be periodically conducted according to a schedule established by rule. Licensees must bear the cost of the investigation. The Department may rely on the assistance of outside agencies, firms, and individuals during investigations.

Agency Costs.

The Department may recover the state's costs and expenses for pursuing violations unless the director determines that no violation occurred.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect on January 1, 2017.