Investors Title Exchange Corporation

INNOVATIVE BY INSTINCT

Volume 10

The Exchange

SECURITY
EXPERTISE
SERVICE

INVESTORS TITLE EXCHANGE CORPORATION

State Regulation of Qualified Intermediaries

By Anna Gregory Wagoner, Title and Regulatory Attorney / Exchange Counsel

There is currently no federal regulation of the qualified intermediary ("QI") industry, which means that anyone who wants to serve as a QI can do so. This non-regulation can lead to disastrous results for the taxpayer who places his exchange proceeds with an unscrupulous QI. In response to recent instances of misappropriation of taxpayer funds by a few qualified intermediaries, certain states have taken it upon themselves to regulate qualified intermediaries who do business in their particular state. The Federation of Exchange Accommodators ("FEA"), which is the QI trade association, has drafted a model QI regulation in hopes that the states will follow its model act when enacting their own regulations. At the present time, seven (7) states have enacted their own versions of the FEA Model Act: California, Colorado, Idaho, Maine, Nevada, Oregon, and Washington. A Virginia Bill goes into effect July 1, 2010. These regulations generally apply if the relinquished property is located in the state, if an Exchange Accommodation Titleholder ("EAT") is taking title to property in the state as part of a reverse exchange transaction, or if the QI maintains an office in the state. Below is a discussion of each state's QI regulations.

California The California law regulating QIs (Senate Bill 1007) went into effect on January 1, 2009. Under this law, each QI is required to maintain fidelity bonding of at least $1 million and errors and omission ("E&O") insurance of at least $250,000. Fidelity bonding is not required if the exchange funds are held in a qualified escrow or qualified trust account. Each QI must invest the exchange funds according to the prudent investor standard with the goals of liquidity and preservation of principal. The exchange funds may not be commingled with the QI's operating account, and the QI may not loan or transfer the funds to an affiliated entity, except to an EAT in the case of a reverse exchange. In the event of a change in control of the QI company, defined as the transfer of more than 50% of the assets or ownership interests, all existing clients with relinquished or parked property (in the case of a reverse exchange) in California must be notified within ten (10) business days. The company must also post a notice on its website for at least 90 days. There is no exemption to this notice requirement for publicly-held companies. Failure to comply with the QI regulations can result in the filing of a civil suit.

Colorado The Colorado law regulating QIs (House Bill 09-1254) went into effect on April 16, 2009. Under this law, each QI is required to maintain fidelity bonding of at least $1 million and E&O insurance of at least $250,000. Fidelity bonding is not required if the exchange funds are held in a qualified escrow or qualified trust account, but any disbursement from a qualified escrow or qualified trust account requires the taxpayer's written authorization. If more than $250,000 of exchange funds are held on behalf of a taxpayer, in any type of account, the taxpayer and QI must approve the withdrawal of said funds. The QI has a fiduciary responsibility to protect and preserve the exchange funds and must notify the taxpayer in writing of the manner in which the funds will be invested. The exchange funds may not be commingled with the QI's operating account and the QI may not loan or transfer the funds to an affiliated entity, except to an EAT in the case of a reverse exchange. Exchange funds may be placed in one aggregated account if the bank can readily identify each client for whom the funds are held. The QI may not give access to funds to a person convicted of a crime involving fraud, deceit, or theft. Exchange funds are not subject to the claims of the QI's creditors. Any violation of these regulations is punishable as a deceptive trade practice under Colorado law.

Idaho The policy statement (Policy Statement #2007-4) subjecting QIs to the Idaho Escrow Act was issued in July, 2007. This Act requires the QI to be licensed by the Idaho Department of Finance unless the QI qualifies for an exemption. Licenses must be renewed annually by April 30. The QI must maintain a $200,000 fidelity bond with a deductible of no more than $10,000, E&O insurance of $50,000, and a surety bond. It must maintain a separate escrow trust fund account at a bank authorized to conduct business in Idaho. The QI must preserve and protect the exchange funds from loss, theft, or damage, and comply with all other fiduciary responsibilities. Exchange funds may not be commingled with the QI's operating account, and the QI must provide each taxpayer with a written, signed closing statement upon the completion of each transaction. A new license may be required upon a change in control or ownership of the company. The QI must have on staff a designated Escrow Supervisor who has at least three (3) years experience in that capacity. Serving as a QI without a license is a felony and may result in civil penalties up to $5000 per violation.

Maine The Maine law regulating QIs (Maine Revised Statute Title 10, Chapter 212-C) went into effect on September 12, 2009. This law requires licensure by the Superintendent of Consumer Credit Protection if the QI engages in any of the activities discussed in the first paragraph or advertises in Maine. Licenses must be renewed by April 30th each year for a $150 renewal fee. Each office doing Maine business must be licensed. Bank QIs and title & escrow companies only acting as qualified escrow agents or qualified trustees are exempt from the licensing requirement. Each QI is required to maintain fidelity bonding of at least $250,000 and E&O insurance of at least $100,000. Fidelity bonding is not required if the exchange funds are held in a qualified escrow or qualified trust account, but any disbursement from a qualified escrow or qualified trust account requires the taxpayer's written authorization. Each QI must invest the exchange funds according to the prudent investor standard with the goals of liquidity and preservation of principal. The exchange funds may not be commingled with the QI's operating account, and the QI may not loan or transfer the funds to an affiliated entity, except to an EAT in the case of a reverse exchange. Exchange funds are not subject to the claims of the QI's creditors. In the event of a change in control of the QI company,

www.1031itec.com

121 North Columbia St.
Chapel Hill, NC 27514
exchanges@invtitle.com

Phone: 800.724.8791
Fax: 800.653.9811

Investors Title Exchange Corporation

INNOVATIVE BY INSTINCT

FEA
Federation of Exchange Accommodators

CES 1031
Certified Exchange Specialists®

defined as the transfer of more than 50% of the assets or ownership interests, all existing clients with relinquished or parked property (in the case of a reverse exchange) in Maine must be notified within ten (10) business days. The company must also post a notice on its website for at least 90 days. There is no exemption to this notice requirement for publicly-held companies. Failure to comply with the QI regulations can result in a claim against the fidelity bond, a civil action, or any other action by the state to ensure compliance. This law also gives the Superintendent of Consumer Credit Protection within the Department of Professional & Financial Regulation the authority to promulgate rules and examine the records of any QI.

Nevada The Nevada law regulating QIs (NRS 205.960 & NRS 645G) went into effect on July 1, 2007. This law requires licensure by the Division of Financial Institutions, although there is currently no licensure process in place. Certain owners, directors, and officers may also be required to be licensed. The license must be renewed annually by July 1. Under this law, each QI is required to maintain fidelity bonding of at least $1 million and E&O insurance of at least $250,000. Nevada law requires exchange funds to be held in a qualified escrow or qualified trust account, and any withdrawal must be authorized by both the taxpayer and QI. The QI has a fiduciary responsibility to invest the exchange funds, and the exchange funds may not be commingled with the QI's operating account. Exchange funds are not subject to the claims of the QI's creditors. The QI must designate an employee who is either an attorney, CPA, Certified Exchange Specialist, or a person that has been actively conducting the business for the three (3) previous years as an "exchange facilitator officer." Violations of the QI laws can result in a Class D felony charge, civil penalties of more than $10,000, a $200/day fine for each violation, and/or suspension or revocation of the QI's license. The FEA is currently working with the Nevada Department of Financial Institutions to enact a QI licensing law.

Oregon The Oregon law regulating QIs (House Bill 3484) went into effect on January 1, 2010. Under this law, each QI is required to maintain fidelity bonding of at least $1 million and E&O insurance of at least $250,000. Fidelity bonding is not required if the exchange funds are held in a qualified escrow or qualified trust account, but any withdrawal from such an account must be authorized by both the taxpayer and QI. Each QI must invest the exchange funds according to the prudent investor standard with the goals of liquidity and preservation of principal. The exchange funds may not be commingled with the QI's operating account, and the QI may not loan or transfer the funds to an affiliated entity, except to an EAT in the case of a reverse exchange. Exchange funds are not subject to the claims of the QI's creditors. In the event of a change in control of the QI company, defined as the transfer of more than 50% of the assets or ownership interests, all existing clients with relinquished or parked property (in the case of a reverse exchange) in Oregon must be notified within ten (10) business days. The company must also post a notice on its website for at least 90 days. There is an exemption for publicly-held companies that remain public after the transfer. Failure to comply with the QI regulations can result in the filing of a civil suit.

Virginia The Exchange Facilitators Act (House Bill 417) goes into effect July 1, 2010. Under this law, each QI is required to maintain E&O insurance, deposit cash, or provide irrevocable letters of credit of at least $250,000. All exchange funds must be held in a separately identified account, with any withdrawal authorized by both the taxpayer and QI, or in a qualified escrow or qualified trust account. The exchange funds may be invested in an investment of the taxpayer's choice. The exchange funds may not be commingled with the QI's operating account and the QI may not loan or transfer the funds to an affiliated entity, except to an EAT in the case of a reverse exchange. Exchange funds are not subject to the claims of the QI's creditors. In the event of a change in control of the QI company, defined as the transfer of more than 50% of the assets or ownership interests, all existing clients with relinquished or parked property (in the case of a reverse exchange) in Virginia must be notified within ten (10) business days. The company must also post a notice on its website for at least 90 days. There is an exemption for publicly-held companies that remain public after the transfer. Failure to comply with the QI regulations can result in a civil penalty of not more than $2500 per violation.

Washington The Washington law regulating QIs (House Bill 1078) went into effect on July 26, 2009. No licensing or registration is required, but the QI must submit to the director of institutions a one-time report of all of its activity from 1/1/2009 to 12/31/2009. Under this law, each QI is required to maintain fidelity bonding of at least $1 million and E&O insurance of at least $250,000. Fidelity bonding is not required if the exchange funds are held in a qualified escrow or qualified trust account, but any withdrawal from such an account must be authorized by both the taxpayer and QI. Prior to entering into an exchange agreement with each taxpayer, the QI must provide evidence to him that the fidelity bonding/qualified escrow/qualified trust and E&O requirements have been satisfied. For exchange proceeds of $500,000 or more, all funds must be held in a separately identified account and the taxpayer must receive all earnings. For exchange proceeds of less than $500,000, a pooled interest-bearing trust account can be used if the taxpayer agrees to it in writing (otherwise the QI must hold the funds in a separately identified account). The QI must provide the client with written notification of how the funds have been invested or deposited. Each QI must invest the exchange funds according to the prudent investor standard with the goals of liquidity and preservation of principal. The exchange funds may not be commingled with the QI's operating account, and the QI may not loan or transfer the funds to an affiliated entity, except to an EAT in the case of a reverse exchange. Exchange funds are not subject to the claims of the QI's creditors. In the event of a change in control of the QI company, defined as the transfer of more than 50% of the assets or ownership interests, all existing clients with relinquished property in Washington must be notified within ten (10) business days. The QI must be under the direct management of an officer or employee who is either an attorney, CPA, or Certified Exchange Specialist. Failure to comply with the QI regulations may result in a civil suit, a Class B felony charge or a misdemeanor charge.

There are also a handful of states that are in the early stages of enacting their own QI regulations: Arizona, Oklahoma, and Texas. The FEA is working with the legislatures of each of these states to encourage adopting provisions that follow the FEA Model Act.

On the federal level, there is a provision in House Resolution 4173 (Wall Street Reform and Consumer Protection Act) to assess the current QI industry. If this bill becomes a law, it would require the Director of the new Consumer Finance Protection Agency to study all federal laws and regulations related to the protection of persons using QIs, submit recommendations to Congress, and implement regulations to ensure the protection of such persons.

Because the standards and practices of the QI industry vary from state to state, it is important to carefully choose a QI who will adhere to these varying requirements. When choosing a QI, a taxpayer should look for the following: (1) a QI that utilizes financially appropriate instruments or accounts to hold funds during the transaction; (2) a QI that has a strong balance sheet and sufficient capital to operationally withstand a downturn in the business cycle; and (3) an institutional QI or QI that is of sufficient size to employ multiple exchange personnel, with robust internal financial controls to guard against embezzlement and employee theft.