

**MINUTES OF THE SUBCOMMITTEE OF THE
SENATE COMMITTEE ON COMMERCE AND LABOR**

**Seventy-fourth Session
February 12, 2007**

The subcommittee of the Senate Committee on Commerce and Labor was called to order by Chair Joseph J. Heck at 9:08 a.m. on Monday, February 12, 2007, in Room 2135 of the Legislative Building, Carson City, Nevada. The meeting was videoconferenced to the Grant Sawyer State Office Building, Room 4412E, 555 East Washington Avenue, Las Vegas, Nevada. [Exhibit A](#) is the Agenda. [Exhibit B](#) is the Attendance Roster. All exhibits are available and on file in the Research Library of the Legislative Counsel Bureau.

SUBCOMMITTEE MEMBERS PRESENT:

Senator Joseph J. Heck, Chair
Senator Michael A. Schneider

STAFF MEMBERS PRESENT:

Kelly Gregory, Committee Policy Analyst
Lynn Hendricks, Committee Secretary
Scott Young, Committee Policy Analyst
Lori Johnson, Committee Secretary

OTHERS PRESENT:

David W. Turner, CPA, Turner, Loy & Company, LLC
Sylvia A. Smith, President/CEO, Western Title Company, Incorporated.
William Uffelman, President and CEO, Nevada Bankers Association
Betty Kincaid
Gail J. Anderson, Administrator, Real Estate Division, Department of Business and Industry
Steven Kondrup, Acting Commissioner, Division of Financial Institutions, Department of Business and Industry
Teresa Story-Turner, Board Member, Federal Exchange Accommodators
Tami Eifert-Ritz, Qualified Intermediary, Western Exchange Service Corporation

CHAIR HECK:

We will open up this subcommittee on Qualified Intermediaries (QIs). On the agenda this morning, Senator Townsend has asked us to look at whether there should be changes to our current statutes governing the practice of QIs, as a

result of the pending problem with Southwest Exchange Incorporated in Las Vegas.

The Research Division of the Legislative Counsel Bureau has provided information and recommendations. We understand the Federation of Exchange Accommodators (FEA) is suggesting model regulation which is not yet available. Our purpose is to enact regulations that will safeguard the public yet not be a financial burden to law-abiding businesses. This meeting will be informal. One recommendation is to require licensing for all QIs; currently Nevada is one of the only states that have a registration requirement, not to be confused with licensing. Are there any benefits to licensing rather than registration? The other suggested requirements are fingerprinting and background checks, which are done as part of the registration requirement.

The larger issues are bonding requirements and errors and omissions insurance (E&O). The recommended requirement is a \$1 million fidelity bond plus \$250,000 in E&O insurance. The suggested \$1 million is an aggregate amount, so I am not sure that is enough. It certainly would not have covered the reported losses of Southwest Exchange. Not being familiar with the cost of bonding, I would welcome comments regarding fidelity versus surety bonding costs.

DAVID W. TURNER (CPA, Turner, Loy & Company, LLC):

I have contacted two insurance agencies to get that information. I expect to have that by the end of the week.

SYLVIA A. SMITH (President/CEO, Western Title Company, Incorporated):

I am here as president of Western Title Company, Incorporated, which owns Western Exchange Corporation. I am also president of the Nevada Land Title Association. We have contacted our insurance agent about the cost of the proposed bonding requirements. For a fidelity bond, that would equal 100 percent of our average aggregate monthly balance exchange funds of \$19 million, we would need 5 separate \$5 million bonds to meet the proposed requirement. Our agent could not quote that cost. Our insurance carrier told us there are only five companies in the United States that can write that amount of a bond. The requirement to have an E&O insurance policy equal to 25 percent of our average balance would require maintaining a \$5 million policy. We currently carry a \$1 million E&O insurance policy, which costs us \$18,000 a

year. By increasing the policy to \$5 million, the estimated premium would jump to \$90,000 a year. This would be prohibitive to our business.

WILLIAM UFFELMAN (President and CEO, Nevada Bankers Association):

I have had several discussions with my banking peers regarding the possible regulations for QIs. I asked them, as banks, if they consider themselves QIs. Responses varied, but all agreed they were not registered as such with the State. Since banks hold their funds subject to federal banking requirements, we would undoubtedly meet any requirements necessary to serve in the capacity as QIs. As an industry, I am not sure we would like to see another license required of us. Certainly, in the effort to know who is registered as QIs, and if the requirement were reasonably priced, we would not have an issue. The banking industry requires fingerprinting and background checks. The criteria of E&O insurance would be met by any organization that falls under the Gramm-Leach-Bliley Act of 1999 (GLB) concerning statutory banking requirements. I have no experience in comparing our operations to a title company or escrow operations. Dual signatures are always required for any funds to be moved within banking operations. No funds deposited by QIs could be withdrawn from a certificate of deposit account unless owners of the fund also sign.

MS. SMITH:

The purpose of using QIs in an exchange is to provide an avenue for the owner to give control of the funds over to a third-party exchange, since the Internal Revenue Service (IRS) does not allow the owner to have control during that interim period. In our particular company, we set up separate interest-bearing accounts. We do not commingle funds. Those monies are kept separate from our operating funds, similar in some ways to escrow funds. Our customers sign specific instructions acknowledging where the funds are to be deposited; we only use Federal Deposit Insurance Corporation (FDIC) banks. We would not want to treat these funds the same as escrow funds as required by *Nevada Revised Statutes* (NRS) 645A.160, since part of the income that the exchange companies earn is in the interest split with the exchanger. Customers agree on the fee structure in advance. Aside from the advance processing fee, our income is a portion of that interest.

SENATOR HECK:

Is your policy of putting all funds in an FDIC bank an extra step not currently required by regulation?

Ms. Smith:

That is something we as a company feel is necessary.

MR. UFFELMAN:

The notion that you split the interest certainly is part of the agreement, but could, in effect, be collected at the closing of the property.

SENATOR HECK:

I would like to concentrate on regulatory issues that would not require additional costs to small business, like significantly increasing bond requirements. Would the kind of protections, such as dual signatures, and having the ability to produce 100 percent of the monies within one business day, be a problem for your companies?

BETTY KINCAID:

As the former owner of Southwest Exchange, I am here as an individual to give input on this subject. I agree with Senator Heck, we need to be careful not to create an environment where small business cannot be profitable. Creating an atmosphere where competition can flourish is the best consumer protection. Deciding the bond amount is not as important as the oversight of bond parameters and making sure consumers are able to find out if bonds are current.

SENATOR HECK:

One of our recommendations for regulation is that the QIs' bond information should be given to consumers when they utilize their services.

Ms. KINCAID:

In addition, whoever the regulatory agency is, they should be informed of any change or cancellation of the any bond being held by QIs.

SENATOR SCHNEIDER:

When the money is deposited by the intermediaries, is there any precautionary regulation of the QIs as to where they can move the money?

Ms. KINCAID:

Not that I am aware of. There have been losses, even in escrow accounts, because of the lack of regulation for the back-office operation. Most accounts are a contractual agreement only. Those funds have no regulatory oversight. Efficient management of those funds relate immediately to the QIs' bottom line.

Most of these companies have a model investment policy regarding liquidity. I think 100-percent liquidity is a great concept but whether it is actually profitable, I do not know. In my opinion, legislation should not dictate the business model.

SENATOR SCHNEIDER:

That raises a good question. Would it be wiser to put these QIs under the Division of Finance rather than the Real Estate Division of the Department of Business and Industry for oversight?

MS. KINCAID:

In my opinion, yes, they need to be under an agency that understands what the back-office process looks like and could spot problems in an audit.

SENATOR HECK:

We will have the discussion of what agency should have authority after we have the regulation framework. Ms. Smith, do you carry a surety or fidelity bond?

MS. SMITH:

We carry a fidelity bond and E&O insurance.

SENATOR HECK:

To recap, current registration requirements are for a \$50,000 surety bond but not an E&O policy. In an effort to not impose significant cost to the industry, we would continue with registration, background checks and fingerprinting. We would also require depositing money into an account similar to an escrow account that would require dual signatures with the exception of escrow-type language because of QIs' fee structure and retention of interest earnings. We need to establish a time requirement for these assets to be made liquid. Provisions should be made for consumers that show the type of bond QIs carry plus notification of change or cancellation of that bond. Should we change the surety bond to require a fidelity bond and E&O insurance? We need to decide on a reasonable amount to require.

MS. SMITH:

We ask for consideration of title company intermediaries, possibly making us exempt, since large title companies are held to higher standards as part of the title company regulation. We are subject to underwriting and State audits similar

to the banking industry. Banking accounting procedures are very strict with regard to trust funds.

SENATOR HECK:

We would be requesting the bonds and insurance as a minimum precaution. If the title company meets the higher requirements as does a bank, nothing more would be necessary.

SENATOR SCHNEIDER:

In the case of an unexpected property being available but only if the consumer could close on the property immediately, are the funds available immediately?

Ms. SMITH:

Our customer funds are available at their request.

Ms. KINCAID:

Our funds were always available to the client. This is a business-model decision. Those back-end funds are managed for maximum profitability as well as maximum liquidity. If your company gets a reputation for not being able to fund quick deals, you will not be able to compete in that market.

Regarding the bonding issue, I am biased toward small, independent companies versus in-house title operations, so I hope we would not see any unfair advantage or consideration given to title intermediaries. They may have audit processes, but those are not necessarily extended to the QIs' process.

I would recommend the minimum bonding amount be dictated by the market. The FEA has the ability to combine these QIs and get fairly good pricing on fidelity bonds. Educating the consumer is important, they need to know what kind of bond should be held, and for what amount, in order to choose which company to deal with.

SENATOR SCHNEIDER:

I do not believe that consumers will understand or investigate the different QIs, because most people do not have that many transactions of this kind. What if you charge a higher fee on the exchange to get your profit and all the interest that accumulates belongs to the owner of the money? Would that be suitable with your fee including the amount of the bond and associated costs?

MS. KINCAID:

That is what will occur, if in fact there is going to be regulation required to segregate accounts. Then the interest would be in a form of a money market account and the cost of the exchange would go up.

MR. UFFELMAN:

Actually, the cost would not go up; it would shift from the accumulated interest to the fee charged.

MS. KINCAID:

The cost to the consumer would still go up. They are going to earn all the interest and have to pay taxes on it. What is happening now is the interest is offset by their fee and the taxes for that interest income is being paid by the intermediary as part of their normal business taxes. The out-of-pocket, post-tax cost to the consumer will go up.

SENATOR HECK:

The regulations we agree on are as follows; we will continue with registration, fingerprinting, background checks and depositing money in a separate trust account. In addition to the dual-signature requirement, we need bond and insurance information made available to the public. A regulatory agency needs to be assigned to keep current with changes or cancellation of insurance or lapse of any bonds. We will continue to require a \$1 million per-occurrence fidelity bond and a \$250,000 E&O insurance policy. All of this is similar to the suggested model legislation from the FEA.

MR. TURNER:

Requiring dual signatures works great, but may not be strictly enforced. In the beginning, rules promulgated by the IRS did not allow sellers using a 1031 exchange to receive any interest earnings. Exchange Accommodators made the most money when the exchange took the full 180 days. If the exchange happened early and there was no interest to earn, the accommodator could also charge an additional service fee. The IRS then issued a ruling that it would be acceptable for the seller to participate in the interest earned to avoid an early payoff fee, as long as the money, in the intervening time, is really in the name of the exchange and not of the taxpayer. If the exchange accommodators start to time their investment maturity dates to when they need funds available to cover deposits, you will need to have audit processes.

Requiring same-day liquidity is unrealistic; most of these funds are being deposited in banks which do not always guarantee same-day return.

SENATOR HECK:

It may be beneficial to include audit requirements in the regulation. It appears that these exchanges might belong under the regulation of the Division of Financial Institutions (DFI) rather than in the Real Estate Division. Fortunately they are both in the same Department, so this move would be revenue-neutral. Could I get your opinion on that, Ms. Anderson?

GAIL J. ANDERSON (Administrator, Real Estate Division, Department of Business and Industry):

That is correct; it would be revenue neutral at least on the part of the Real Estate Division. Right now we perform the registration process of approximately 50 intermediaries which is a small blip in the licensing department. The only audit function we perform is with property-management permit holders who are required to submit an annual reconciled financial statement which is reviewed by a staff member. We do not have a full-time staff auditor. I agree with the recommendation to move the accountability of QIs to the DFI. As part of the registration process, I would recommend listing these facilitators online; the same as we are currently considering doing with our licensed real estate agents, so the public can see if they are active and check their bonding status.

STEVEN KONDRUP (Acting Commissioner, Division of Financial Institutions, Department of Business and Industry):

I agree with the recommendations you are considering and the fact that this move would be revenue neutral. The DFI could handle this process. It is possible we would need an additional staff person in the licensing division. We currently monitor the bonds of other industries we regulate and background checks are done by our Division.

SENATOR HECK:

We will consider transferring the monitoring of QIs to DFI authority.

TERESA STORY-TURNER (Board Member, Federal Exchange Accommodators):

I am a board member with the FEA. Learning from the Southwest Exchange case, we need to verify new owners' backgrounds as soon as possible, before the sale can be completed. The general public only learned of this sale

two years after the fact. We should not lose sight of this necessity in future oversight.

SENATOR HECK:

Assuming we go forward with the proposed regulation, the new buyer would be required to have background checks done before the sale could go forward.

MS. ANDERSON:

For a corporation to register as currently required by statute, all officers and directors must all be qualified, registered intermediaries. No other employees are required to be registered.

MS. SMITH:

I previously stated that we currently use the dual-signature requirement. I need to clarify that was at an internal level only. The IRS has been very clear that the idea of a "safe harbor" created by the exchange handling these funds is that the owner/seller is removed from that process and has no control over those funds in that intervening period of time. Therefore, the dual signatures of owner and exchanger may create a problem with the IRS. Perhaps, the FEA has already addressed that in their model legislation.

SENATOR HECK:

Could we check that potential requirement and make sure we have considered any conflict with existing statutory IRS rule.

SENATOR SCHNEIDER:

The chairman suggested a \$1 million bond per transaction and \$250,000 E&O insurance. What is the typical amount you need to cover?

MS. STOREY-TURNER:

As a former employee of Southwest Exchange, I could make a guess that yearly transactions could range between \$30,000 to an amount equal to 40 percent of total transactions. With the recent appreciation of real estate, it would not be unusual to see exchange proceeds of over a million dollars annually, at least here in southern Nevada. Yearly national averages can vary, given the size of the exchange company.

TAMI EIFERT RITZ (Qualified Intermediary, Western Exchange Service Incorporated):

I agree with the average amount running from \$30,000 to \$500,000. It can vary widely.

SENATOR HECK:

My feeling is that the \$1 million should be adequate for the average consumer who does not use this service on a regular basis. For people who make a business flipping these properties, they would be more knowledgeable about the exchange intermediary they choose.

A final consideration is what criminal penalties should apply for these new statutes and potential new regulations. Failure to comply would be grounds for disciplinary actions. If a customer suffers a loss of more than \$5,000, then it would be considered a Class C felony. Are there any other concerns regarding language to that effect?

MS. ANDERSON:

I recommend this regulatory agency also be given the authority to monitor any unregistered or unlicensed QIs' activity. Since the Real Estate Division received that authority, we have effectively stopped unlicensed real estate activity in some significant cases.

MR. KONDRUP:

I agree with Ms. Anderson. You will always have individuals who want to stay away from background checks and other monitored activity.

MS. SMITH:

For the Nevada Land Title Association, we wholeheartedly agree, since we handle these types of funds. We suggest the penalties are appropriate.

MR. TURNER:

Regarding the penalties, if the losses rise to the act of embezzlement, we do not want to take any actions that would override any statutory penalties.

SENATOR HECK:

Good point, Mr. Turner. We will look further into that and make sure we do not come up with conflicting or more restrictive penalties.

MS. ANDERSON:

When a transaction is being closed, we need to make sure a check is done to see if both intermediaries are registered in Nevada.

MR. KONDRUP:

The regulatory agency should be notified immediately of any change in ownership or change of corporate structure or officers of the QIs.

CHAIR HECK:

The hearing on QIs is now closed. The other item Senator Townsend requested we discuss is the regulation of payroll-service providers. This has come to light due to problems with providers in other states. Potential legislation has been introduced in Maine, Minnesota and Rhode Island. Nevada does not currently regulate payroll-service providers. I have a document from the National Payroll Reporting Consortium, Incorporated; in the first page they put this possible problem area into the right context, "consider that 99.99 percent of this industry has not suffered any losses." In view of this, we need to be careful that we do not force more governmental regulation that might burden small businesses. Since we have not seen any problems in Nevada, we need to proceed lightly.

MR. TURNER:

We actually have two pending cases in Nevada. One of my clients has suffered a loss of \$700,000 from a company called Accuserve Incorporated, in southern Nevada. There is also a pending case in northern Nevada regarding the company called Quick and Easy Payroll Services, Incorporated. I understand the magnitude of losses from Accuserve is approaching over a million dollars, including the loss of my client as I stated. I am not aware of the details regarding the loss in northern Nevada, but the owner was arrested in New York and extradited and is in Washoe County Jail.

SENATOR HECK:

I suggest that many of the regulations that we are attempting to establish with regard to the QIs would follow for payroll-service providers. Are there any other comments?

MR. TURNER:

The major difference in the QIs versus payroll services is that payroll-service providers rely on electronic fund transfers (EFT). These are what the financial

industry terms automated clearing house services. I do not believe that QIs use this type of money transfer. With EFT and the ability to move money to any place in the world, the potential for loss is huge and currently there are no regulations of which I am aware. My client's loss from Quick and Easy Payroll Services was a result of using EFT. My client had given authorization for the company to use this electronic method of moving money from my client's account to the company's account in order to process payroll and make tax payments. Instead of using the monies as agreed upon, the monies disappeared. We need to look at regulating this potential problem area. I believe this regulation would also belong in the DFI titles. We should consult with the National Payroll Reporting Consortium.

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SENATOR HECK:

Apparently in Maine, they place the regulation in their taxation department. Since there are no representatives from payroll services industries, we will report what we have to Senator Townsend and explain that we require further study and contact with the National Reporting Consortium. We will conclude this subcommittee at 10:07 a.m.

RESPECTFULLY SUBMITTED:

Lori Johnson,
Committee Secretary

APPROVED BY:

Senator Joseph J. Heck, Chair

DATE: _____