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National Electronic Conveyancing System

Implications for financiers and solicitors

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National Electronic Conveyancing System - Implications for financiers and solicitors

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This paper is being delivered in conjunction with presentations by Mr Simon Libbis, Executive Director, National Electronic Conveyancing Office (**NECO**) and Mr Ian Gilbert, Australian Bankers Association, Sydney. It addresses developments in thinking about the legal issues affecting the establishment of the National Electronic Conveyancing System, especially those developments which have occurred in the last 12 months.

1 Background

To begin with, for those of you who are not familiar with the background to the establishment of the National Electronic Conveyancing System (**NECS**), I recommend a visit to the website established by NECO: www.necs.gov.au

On the site, the following are published:

- 1 draft National Business Model for the establishment of a national electronic conveyancing system (Version 10 - June 2007);
- 2 National Implementation Strategy for the establishment of a national electronic conveyancing system (Version 6 – June 2007);
- 3 draft National Governance Arrangements for the establishment and operation of a national electronic conveyancing system (Version 9 – June 2007); and
- 4 draft Operations Description for a national electronic conveyancing system (Version 6 – June 2007).

This draft documentation has evolved over a period of 4 years and is now reaching a level of maturity where financiers and solicitors will be able to identify issues affecting their business at a level of detail that is very specific.

In the latest round of documentation which was published in June 2007, NECO has adjusted the Business Model (and the other documents) to take account of recommendations published in March 2007 in the following 2 reports which were commissioned by NECO:

- Risk Assessment of the NECS, final report to the National Steering Committee (of NECO) dated 9 February 2007 by law firm Clayton Utz; and
- Regulatory Review – preparatory analysis for the NECS (March 2007) prepared as a final report to NECS by The Allen Consulting Group and Gilbert & Tobin lawyers.

Each of these reports analyses the applicable issues at a level of detail which is difficult to summarise in a paper to be given in a 20-30 minute time slot. Nevertheless, I propose to survey the topics which have been covered in these reports, to summarise some of the key findings and to discuss some of the risks which have been identified as material with

particular emphasis on those which are not found in the existing paper based conveyancing system.

For the purposes of this presentation I have necessarily reproduced extracts from all of the documents referred to above.

2 Structure of NECS

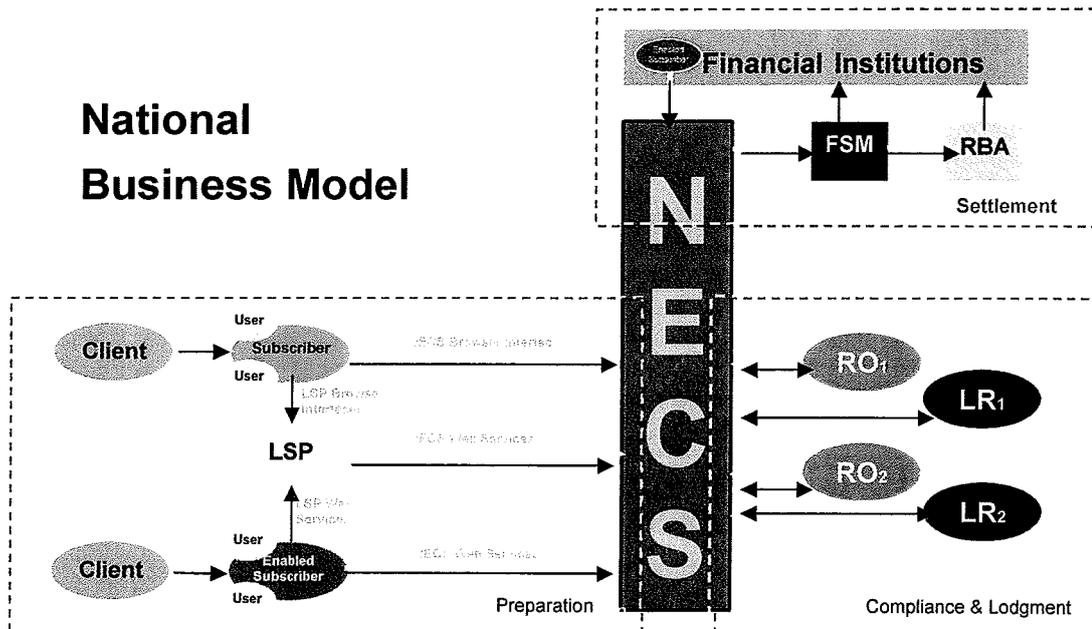
Before commencing an examination of the legal issues, it is helpful to consider (at a high level) the legal structure which is recommended for the conduct of the NECS. Details can be found in the report of corporate advisers Dench McClean Carlson issued in February 2007 and published on the NECS website: www.necs.gov.au.

It is suggested that the system should be owned and controlled by a Corporations Act company to be known as NECS Pty Ltd. Each state and territory government would own an equal number of shares in that company.

The business of NECS Pty Ltd will be managed by another company (a subsidiary) known as NECS Operator Pty Ltd. It is anticipated that most functions and requirements of NECS Pty Ltd will be provided to NECS by third party suppliers under services contracts.

2.1 Legal Relationships

I am reproducing below a diagram found in Version 10 of the draft National Business Model which summarises the relationship between each of the operational roles. Each of these roles is described in significant detail in Part 9 of the draft National Business Model. I will elaborate on each of these roles when I discuss the relationships represented in this diagram:



2.2 Glossary

This is a guide to the terms used in the diagram above (again summarised from Part 8 of the draft National Business Model).

Clients are registered proprietors, purchasers, vendors, mortgagees, mortgagors, caveators and others with an interest in land. Their role is to choose and instruct a Subscriber to act on their behalf (through the subscribers, users and certifiers).

Subscribers are corporations, partnerships, associations, government agencies and sole traders representing (or being) Clients and employing, contracting or being legal practitioners, licensed conveyancers (or others) to prepare, certify and sign registry instruments, information reports and settlement statements.

Users are employees or contractors of Subscribers who work under the day to day direction, supervision and control of a Subscriber.

Certifiers are Users who are legal practitioners or licensed conveyancers (or others) especially delegated or empowered to certify and sign registry instruments, information reports and settlement statements on behalf of the subscriber or its clients.

Licensed Service Providers are businesses providing tailored interfaces, integration and support services to subscribers as an alternative to direct access to NECS.

FSM is the financial settlement manager and provides proprietary financial settlement services through access to RITS for irrevocable settlement of monies payable between financial institutions.

LR are land registries in each jurisdiction which maintain a Torrens Title Register of Land and interests in land, provide the registration service, and determine regulatory controls etc.

RO are revenue offices in each jurisdiction and administer the requirements for payment of duty and taxes associated with property transactions in each relevant jurisdiction.

2.3 Web of contracts

The role relationships set out in this diagram depend on a web of contracts. The relationships will not be legislated and the roles, responsibilities and risk allocation will occur by contract as a result of recommendations in the risk assessment report of Clayton Utz which is discussed in greater detail in Part 3 below. This report was produced after extensive consultation with stakeholders. Many of you may have been involved in that consultation.

3 Risk assessment of the NECS

As mentioned above, Clayton Utz provided the National Steering Committee of NECO with its risk assessment of the NECS on 9 February 2007 ("Risk Report"). It is a comprehensive report. It addresses risks which will be applicable to the actual operations of NECS as described in the diagram that is reproduced in Part 2.1 above.

At the request of NECO, the Clayton Utz report is confined to risks associated with operation of NECS. It expressly excludes any consideration of:

- project risks associated with the design and implementation of NECS;
- regulatory risk issues which are the subject of the separate regulatory review paper discussed in Part 4 below; and
- issues associated with Corporate Governance of NECS and related issues associated with funding the establishment of NECS.

In this paper, I will focus on risks which have the most direct relevance to financiers and solicitors. In doing so, I will reproduce some materials which appear in Part 13.3 of the National Business Model for the establishment of the National Electronic Conveyancing System.

3.1 Subscriber risks

As generally applies to existing paper based arrangements, Subscribers remain responsible for:

- obtaining full and proper instructions from their clients;
- ensuring accurate and complete advice to their clients;
- obtaining a written authorisation to act for each client;
- ensuring all prescribed processes are fully and properly conducted (including client identity verification);
- ensuring all prescribed documentation is fully and properly prepared, signed and securely retained;
- ensuring all instruments and settlement instructions are fully and properly completed, certified and signed;
- assuring the relevant actions of Users working under their directions and control; and
- ensuring all actions undertaken by them, or a User or Certifier working under their direction and control, on behalf of a client are fully compliant with relevant legal, policy and procedural requirements.

These responsibilities are enforced through a participation agreement with the NECS including a commitment to Participation Rules to which every Subscriber must commit as part of the registration process. This commitment enables each Subscriber to rely upon the conduct and certifications of all other Subscribers and their Users and Certifiers participating in the same transaction.

There is a material risk for Subscribers if there is a misdirection of disbursements from a financial settlement. It would be strongly desirable to require 2 different Certifiers to independently certify and sign certain settlement statements.

3.2 Financial institution risks

Each financial institution carries responsibility for:

- ensuring the security, accuracy, integrity, reliability and compliance of its systems interacting with the NECS;
- ensuring its obligations generally as a Subscriber under the Participation Rules are fully complied with;
- ensuring its Users and Certifiers are fully trained and properly delegated, empowered and authorised to act on its behalf; and
- ensuring the availability of cleared funds is properly certified for each settlement.

Just as with Subscribers generally, there is a material risk for financial institutions in the misdirection of payments in a financial settlement.

3.3 General observations

In producing the proposed risk management framework, Clayton Utz stated:

'We consider that the substantial core system rules which govern the relationship of Subscribers and the NECS operator need to be nationally uniform, while other rules may be jurisdiction specific¹.

¹ See first paragraph of Part 1.7 of the Risk Report.

The report goes on to observe that the core uniform rules could be created by a uniform State and Territory statute or subordinate instrument, but in [Clayton Utz's] opinion, it would take considerable time and effort to establish and maintain the relevant intergovernmental agreements and processes to ensure this. Instead, [Clayton Utz] assumed throughout the report that the system rules will take the effect as a contract (in some respects as a deed – a contract under seal) and that there will be adequate statutory authority in each jurisdiction for land registries to implement a contractual approach. The reasoning is because they believe a contractual framework is more likely to create and maintain a nationally uniform set of rules with less time, effort and complexity than each of 8 jurisdictions creating and maintaining a uniform subordinate legislative instrument or exercise a statutory power to give the rules statutory force in each jurisdiction. In managing risk, Clayton Utz therefore used contractual principles, exclusions and limitations of liability and indemnities in relation to the core system rules.²

In the Risk Report, the authors focused on risks presented by the draft National Business Model, endeavouring to put aside the large number of risks which are already present in conveyancing transactions and which are unaffected by the draft National Business Model. Examples given included the risk of a solicitor or conveyancer not keeping an adequate file of a transaction, the risk of misleading information in a vendor's statement etc.³

In part 6.2 of the Risk Report, the authors of the report set out specific mitigation treatment options for identified material risks and responsible roles. In Part 3.4 below I provide by way of example, the recommendations for the Certification Authority/Registration Authority, for a Certifier, for a Financial Institution and for a Subscriber. These provide examples of the methods by which particular risks faced by those parties can be managed to the extent reasonably possible.

It appears that solicitors and conveyancers will take on more rigorous responsibilities in NECS than in paper conveyancing (for example, in relation to identification and registration of themselves as a subscriber to the NECS operator, client identification, certification as to client identity and authority to act and certification as to the correctness of instruments and statements)⁴.

3.4 Risk Mitigation Table

Role	Mitigation treatment options attributable to the role
Certification Authority (CA)/Registration Authority (RA)	<ul style="list-style-type: none"> • Ensure verification of applications for digital signature certificates (DSCs) with Subscriber organisations/individuals • Implement best practice pre-employment checks to verify potential employees; • Set appropriate access levels for staff; • Develop exception notification procedures and suspend administrator access where necessary; • Establish policies and procedures in relation to the

² See Part 1.7 of the Risk Report.

³ See Part 3.5 of the Risk Report.

⁴ See the third paragraph of Part 1.12 of the Risk Report.

issue and revocation of DSCs;

- Maintain audit trails;
 - Develop and test a Business Continuity Plan; and
 - Monitor and report on compliance with NECS/CA Service Level Agreement
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Certifier (CE)

- Undertake and maintain adequate records of client Verification of Identity checks (may be a Subscriber's obligation depending on the nature of the Subscriber/Certifier relationship);
 - Enter into and maintain accurate records of its Representation Agreement;
 - Read and understand NECS System Rules;
 - Ensure DSC security is maintained via physical and technological means;
 - Follow policies and procedures developed by NECS Operator and Subscriber re workflows, system access etc;
 - Record instructions provided by client and verify against workspace before signing Instruments or Statements (whether prepared by the Certifier or by a User);
 - Complete simulated NECS transactions before undertaking actual transactions in NECS; and
 - Hold and maintain adequate Professional Indemnity insurance (see our discussion regarding whether a Certifier should be covered by their associated Subscriber's PI insurance cover).
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Financial Institution (FI)

- Require two Certifiers to sign and confirm availability of funds for settlement (as per Draft NBM);
 - Develop processes and procedures around the use of dual certification;
 - Retain audit trails;
 - Verify that transaction batch data matches expectations prior to and following settlement;
 - In consultation with peak bodies and NECS Operator, develop conveyancing Industry Protocols and NECS workflows;
 - Establish (at the industry level) protocols to be applied where an FI Subscriber is to certify another non-Subscriber FI's customer's funds;
 - Have in place best practice physical and technological security measures; and
 - Develop and test a Business Continuity Plan.
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Subscriber(s)

- Meet requirements for registration established by NECS Operator (including, for example, security mechanisms, insurance etc);
- Put in place processes and procedures to monitor and, where necessary, verify the conduct of Users and Certifiers;
- Keep an electronic record of information entered into a Workspace;
- Develop processes and procedures for entering into and maintaining accurate records of Representation Agreement;
- Acquire appropriate physical and technological mechanisms for protecting records;
- Keep records of system activity;
- In consultation with peak bodies and the NECS Operator should develop standard contract forms, e-conveyancing protocols and NECS workflows;
- In consultation with peak bodies, develop policies and guidelines for Client authority verification including powers of attorney, corporate and trustee clients;
- In consultation with peak bodies develop professional conduct rules.

3.5 NECS risk management framework – recommended liability transfer and insurance framework

According to Part 13.1 of the draft National Business Model, the risk assessment used the following performance objectives for a risk management regime:

- confidence among participant groups that there is no net increase in their risk or liability exposure;
- confidence among participant groups and the general public of the same levels of the integrity and security as in paper conveyancing;
- assurance that all legal and regulatory mechanisms preventing, mitigating or allocating risks are applied consistently and provide clear and specific guidance to participants;
- allocation of risks and liabilities to the participants able to prevent or mitigate those risks at least cost;
- reliance on existing or additional insurance and/or compensation systems to cover residual risks and liabilities.

In the Risk Report, Part 7.13 contains the summary of liability transfer and insurance recommendations. These may be distilled as follows:

(a) **Subscriber – Client**

Solicitors and conveyancers currently limit some aspects of their liability in their retainer agreements. Similarly, financial institutions limit their liability to their customers by contract. In the Risk Report, it is recommended that Subscribers should not be able to transfer significant risks arising from NECS to their clients or customers using their retainer or customer agreements (other than to “back to back” liability limitations of the NECS operator to the subscriber).

(b) Risk mitigation measures

Service agreements, participation rules, industry protocols and professional practice regulations will contain relevant obligations for risk mitigation. We have set out some examples in the table in Part 3.4 above which will affect financiers and solicitors.

(c) Risk transfers

There will be some risk transfers effected through comprehensive Participation Rules which are to be implemented as bilateral contracts between Subscribers and NECS as well as back to back indemnity agreements with service providers to the NECS such as the FSM and DSC suppliers.

(d) Liability Insurances

Liability insurances will be particularly relevant to Subscribers and Certifiers. The availability of adequate professional indemnity cover is essential. Similarly, NECS will need to secure market insurance for its residual risk in any transaction capped by the Participation Rules at the value of the interest that is to be conveyed.

In the Risk Report, it is suggested that if NECS is unable to secure market insurance, the fall-back position should be a compensation fund separate from each of the existing Torrens Assurance Funds.

4 Regulatory Review

In summary, the Regulatory Review conducted by The Allen Consulting Group and Gilbert & Tobin ("Regulatory Review") concluded that there is little risk of regulatory intervention in the establishment and operation of NECS so long as NECS conducts itself in particular ways.

4.1 Competitive neutrality regulation

The Regulatory Review considered that NECS is not subject to the National Competition Principles. However, it recommended that NECS conform with the principles to ensure that it operates efficiently. In particular, it should:

- charge fees fully reflecting its operational costs;
- include in its fees all government taxes, duties and charges which apply to private sector businesses;
- pay commercial rates of interest on its borrowings;
- generate commercially acceptable profits; and
- comply with the same regulations that apply to private sector businesses.

4.2 Trade Practices

The Regulatory Review considered that NECS will be subject to certain requirements of the *Trade Practices Act, 1974* (Commonwealth). It suggests the following steps, among others:

- authorisation should be sought from the ACCC for the approach to be taken by NECS to establish minimum requirements of Subscribers (to avoid breaching the exclusionary provisions of the Trade Practices Act).
- Authorisation should be sought from the ACCC for the fee setting methods to be used by NECS (to avoid breaching the price fixing provisions of the Trade Practices Act).

4.3 Financial Services Regulation

According to the report, NECS will not be providing any financial products or services that would necessitate holding an AFS licence under the Corporations Act.

4.4 Money Laundering Regulation

Because NECS will be an intermediary between reporting entities under the Anti-Money Laundering and Counter Terrorism Act, it will have obligations under that legislation. It will need to ensure that account numbers and reference details are transmitted with settlement instructions. NECS should not permit settlement payments to be made to accounts outside Australia. If it does so, it may become a designated service for the purposes of this legislation.

4.5 Privacy Protection Regulation

NECS will certainly be subject to the *Privacy Act 1988* (as amended) and it will need to take a considerable number of steps to ensure compliance with this legislation in the way in which it permits collection of information and dealing with information in its processes.

4.6 Payment Systems Regulation

NECS is a payment system that could be designated and regulated by the Reserve Bank of Australia for access and fee setting in the public interest under the *Commonwealth Payment Systems (Regulation) Act, 1998*. Clearly, NECS will need to have regard to this when applying its fee setting principles and designing its minimum necessary requirements for subscriber access.

The Regulatory Review also found that NECS could eventually be designated by the Reserve Bank Australia under the *Commonwealth Payment Systems (Netting) Act* to provide protection for transacting parties in the netting of chain settlements in the event of a mortgagee becoming insolvent. This will depend on NECS reaching significant milestones in the total value of settlements passing through it.

Finally, the review also found that it would be prudent for NECS to comply with APRA's standards for any significant outsourcing arrangements which are entered into resourcing its services. This will be important because the business model calls for services to be substantially outsourced.

5 Concluding Remarks

I trust that by focussing on risks associated with the roles of financiers and solicitors in the National Electronic Conveyancing System, we will provoke some further debate about the very important issues which have been the subject of the reports delivered during 2007.

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