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July 26, 2004

Ms. Jennifer Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Via email to regs.comments@federalreserve.gov

Re: Docket No. R-1202

Dear Ms. Johnson:

Please accept these comments on the proposed revisions to Regulation J. Please note that the comments that follow do not necessarily reflect the views of any organization with which I am associated, including Indiana University. These are my own thoughts on the draft amendments and any mistakes contained in this comment are my own responsibility.

This comment covers three issues. These are: (1) the definition of the term “item” for purposes of collection through Federal Reserve banks, (2) the use of the terms “party” and “person” in the draft amendments, and (3) the processing of information in the MICR line of the original check. In each instance, these comments are intended to ensure clarity in the final amendments to Regulation J, and the maximum harmony with the Uniform Commercial Code as is possible.

Definition of the term “item” – The primary goal of these draft amendments to Regulation J is to facilitate receipt and processing of electronic images of original checks by Federal Reserve Banks. To achieve this goal, Regulation J must contain a definition of the new “thing” that the Reserve Banks will take, process, transfer, present, or return. The draft amendments suggest that the new term “electronic item” is a subset of the class of “items” that Reserve banks will handle and that Regulation J will govern. It is important that the term be defined as clearly as possible and that the definition signal to everyone concerned that this new term pertains only to items handled by Reserve Banks.

The new term “electronic item” does not refer to a new class of negotiable instruments because there is no statutory authority for such a class and, as a result, the “thing” called an “electronic item” must be a subset of “items” that Reserve Banks will handle. There appear to be two alternatives to the clarification I suggest. The first would remove the proposed draft language from the definition of “item” and place it separately among the definitions in Regulation J. The content of the definition would be identical to the first sentence of the draft definition, but the reference to Section 210.2(i) would need to be completed and the new definition would not include the second sentence of the draft definition. The other would leave the definition of the “electronic item” within the definition of “item” but would clarify that “electronic item” is a subset of “item” solely for purposes of Regulation J. A benefit of both of these would be to lessen the risk that someone will confuse the Regulation J definition of “item” with that in Article 4 of the Uniform Commercial Code.

Uses of the terms “party” and “person” – The draft amendments make frequent use of the term “party,” which is a term not defined in Regulations J or CC, but which is defined in Section 1-201(29) of the Uniform Commercial Code. U.C.C. § 1-201(29) (2001) (the version in effect in all states except Virginia and Texas). The UCC definition includes both someone who participated in a transaction and one who makes an agreement pursuant to a transaction. The draft Regulation J amendments also use the term “person,” albeit less often. (One such use of “person” is in draft section 210.6.) The word “person” is defined in Section 1-201(30) of the Uniform Commercial Code. U.C.C. § 1-201(30) (2001). “Person” includes individuals, entities and all types of organizations; as such it is a considerably broader term than “party.” To complicate this conversation, the term “party” in negotiable instruments law is narrower than the UCC definition in § 1-201(29). It covers only someone who has signed a negotiable instrument as a maker, drawer, indorser, or acceptor and whose signature represents one of the specialty contracts long recognized under negotiable instruments law.

As it finalizes these amendments to Regulation J, the staff may wish to reconsider whether the UCC definition of the terms “party” and “person” work in the contexts in which the staff intends them. It may be that use of the term “person” will work for all of the locations in which either “person” or “party” are used in the draft amendments. The outcome of this review will affect the scope of the sender’s agreement and of the new warranties and indemnities made when one handles an “electronic item” under Regulation J.

[References to the term “party” appear in draft §§ 210.5(a)(2)(iii), 210.5(a)(4)(ii), 210.5(b), 210.6(b)(10)(iii), 210.6(b)(3)(i)(B), 210.12(c)(2), 210.12(e)(1)(i), and 210.12(e)(1)(iii)(2) (two references).]

“Replicating” the MICR line of the original check – Draft § 210.5(a)(4), among others, impose on the sender of an “electronic item” that is not a representation of a “substitute check” a new warranty that, among other things, the item “replicates the MICR line of the original check, except for any changes required or permitted by Regulation CC for

substitute checks;...” It appears that the goal of this portion of the new warranty is to facilitate the subsequent creation of substitute checks that carry information in the MICR line that complies with Regulation CC. To achieve greater clarity in terms of both the data processing of the “electronic item” and the relationship of this electronic item to future substitute checks that might be created from it, I suggest that this portion of § 210.5(a)(4) be amended as follows:

...replicate the MICR line of the original check, except as permitted or required by generally applicable industry standards to facilitate the processing of electronic items and substitute checks.

Another value of the language I suggest it that it parallels the usage of “generally applicable industry standards” as Check 21 and the proposed amendments to Regulation CC to implement Check 21 use that term and provides for smooth transitions to future changes in industry standards such as the ANSI X9.37 standards.

Please feel free to call me if you have questions about my comments or require clarification regarding the issues I have raised. Until August 24th, I can be reached at 508-627-3841 (home) or at 812-327-2083 (cell). After August 24th, please call me at my office in Bloomington, where the telephone number is 812-855-6318.

Sincerely yours,

Sarah Jane Hughes
University Scholar and
Fellow in Commercial Law