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Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Re: Docket No. R-1409, RIN No. 7100 AD 68

Dear Robert:

The Retail Payments Office (RPO) at the Federal Reserve Bank of Atlanta, which manages the Federal Reserve's check and ACH services on behalf of the twelve Federal Reserve Banks, appreciates the opportunity to comment on the proposed amendment to Regulation CC.

In general, the RPO is and has been very supportive of the efforts by the Board of Governors to facilitate the transition from paper check collection and return to electronic check collection and return. We believe that the enactment and implementation of the Check 21 Act has been a terrific success story, in no small part because the Board staff has done a very good job of envisioning how legal and regulatory changes could facilitate the transition from paper to electronics.

We see the current proposed amendment to Regulation CC as a generally positive update to the regulation. We support the Board's proposed update to Regulation CC in light of the very rapid changes that have taken place in bank to bank check collection and return over the past ten years. As noted below, we have identified some areas of potential concern that we believe the Board should consider further.

RETURN REQUIREMENTS

Regulation CC currently imposes two specific requirements on a paying bank that dishonors a check. First, there is a duty of expeditious return. Second, Regulation CC requires a notice of nonpayment if a paying bank returns an item in an amount greater than \$2,500. With the consolidation of Federal Reserve Bank check processing into a single zone across the entire country, it has been clear for some time that the expeditious return provisions in Regulation CC would need to be updated. It is also widely understood that the current expeditious return

requirements operate as a perverse incentive with respect to banks of first deposit that have been slow to agree to image return processing. The Board has proposed two alternatives, the first of which would essentially eliminate the expeditious return requirement and the second of which would require a paying bank to return expeditiously (within a two day deadline) if the paying bank agreed with the bank of first deposit or with a returning bank to send returns electronically to the bank of first deposit. The paying bank would not be subject to an expeditious return requirement if there were no agreement through which the paying bank could send an electronic return to the bank of first deposit.

The RPO's responses to the two alternatives are as follows:

Alternative 1

In construct, Alternative 1 eliminates the expeditious return requirement, moves the deadline for receipt of return items by the bank of first deposit from 4:00 p.m. local time to 2:00 p.m. local time, and requires notice of non-payments of items returned as paper by the paying bank. The notice of nonpayment provision would include the following exceptions: (i) Paying bank has an agreement with the bank of first deposit to send paper returns; (ii) The paper return is received at the bank of first deposit by 2:00 p.m. local time on the second day after presentment was made to the paying bank.

The RPO does not favor this alternative as we feel it places undue burden on depository banks who choose to be electronic receivers of returns, but who may receive electronic returns outside of the two-day window believed to be the norm in the proposal. In these cases, the depository bank is left with no recourse for a potential loss, i.e. there is no longer an option to claim late return, and the funds will have been released at open of business on day two after deposit. There is also the possibility, though not immediately likely, that without the expeditious return requirement a participant in the return process (paying bank or returning bank), acting in its own best interest and acting in the course of general business, may reexamine cost/risk profiles and choose to slow returns.

The RPO offers the following responses to the Board's specific questions regarding Alternative 1:

The elimination of the expeditious return requirement probably would not slow down the entire return check process, but could in some cases result in individual participants slowing their activities where using a slower process would reduce costs for the paying or returning bank. A clear result of the elimination would be the shift of the risk/cost profile from the paying or returning bank to the bank of first deposit. In this proposed environment, depository banks would be unable to recover for returns that met the midnight deadline but were slow in arriving, leaving the bank of first deposit exposed to potential loss in instances where even an electronic return is

slower than two days, i.e. when multiple returning banks may be involved, or in the odd case where a participant slows their return processing.

We do not think that the notice of non-payment should be eliminated. The notice of non-payment is for the benefit of the bank of first deposit, and the proposed elimination of the expeditious return requirement, as noted earlier, shifts risks from the paying bank to the bank of first deposit. Retaining the notice requirement might help balance the risks between the paying bank and the bank of first deposit. Raising the notification requirement to something higher than \$2,500 is a better alternative than eliminating it.

Alternative 2

In construct, Alternative 2 retains the two-day expeditious return requirement for electronic return items, eliminates the four-day rule, eliminates the expeditious return requirement if the payor bank does not enter into agreements that enable it to send returns to banks of first deposit electronically either directly or through a returning bank, moves the deadline for receipt of return items by banks of first deposit from 4:00 p.m. local time to 2:00 p.m. local time, eliminates notice of non-payment, and provides an exception to the paying bank's expeditious return obligation if there is no direct or indirect electronic agreement in place for image return to the bank of first deposit.

The RPO prefers Alternative 2, with the following comments and caveats.

The RPO believes that the proposal to move the deadline for delivering a return item from 4:00 p.m. to 2:00 p.m. may be less than optimal in light of a general industry movement toward later processing cutoffs, not earlier ones. We understand the desire to synchronize the return cutoff for returned checks with the traditional 2:00 p.m. cut off for forward presentments, and we understand that moving the return deadline back two hours reduces the window of potential financial exposure for the bank of first deposit. But given an environment in which the industry as a whole is moving to later exchanges, it might make sense to soften the proposed new return deadline, perhaps by permitting the bank of first deposit to set a cut off time for return items no earlier than 2:00 p.m. local time, while permitting banks to agree to later cut off times for returns if they choose to do so. This approach would precisely synchronize with the way that section 4-108 of the Uniform Commercial Code establishes the cut off time for checks, i.e. by permitting each bank to establish a cut off time at 2:00 p.m. "or later." If the Board's desire is to align the deadlines for presentment and return, it would make sense to permit each bank of first deposit to establish its return cut off time no earlier than 2:00 p.m., thus leaving the bank of first deposit free to agree to a later cut off hour if it chooses to do so.

The Board requested comment on the extent to which an electronic returned check that must be processed by two returning banks would be unable to be delivered to a depository bank within the proposed deadline. There are instances where a single returning bank may meet the two-day test of return by 2:00 p.m. (proposed) on the second day after the day of presentment, but still put the two-day hold requirement at risk, based on presentment times and the timing of the release of the hold on the second business day. This leaves the depository bank with some risk exposure, as it may have released funds the morning of the second day, but prior to the appropriate return of an item by 2:00 p.m. later that same day. The RPO believes that in most instances considered in the current industry-wide processing environment, the return of a check through multiple returning banks could likely result in the returned check not reaching the bank of first deposit by 2:00 p.m. on the second day after presentment. Often, the second returning bank will not be able to deliver a return by 2:00 p.m. on the second day after presentment, and if Regulation CC requires all returning banks to warrant that they will deliver returns to banks of first deposit by 2:00 p.m. on the second day following presentment, some returning banks could make a business decision not to accept returned checks from prior returning banks unless the second returning bank is able to obtain contractual protection against the risk that it may be unable to deliver returns to the bank of first deposit expeditiously.

Proposed Alternative 2 appears to create the correct combination of incentives for paying banks and banks of first deposit to move to electronic return, with one possibly significant exception. The phrasing “[a] paying bank would not be subject to the expeditious-return requirement under Alternative 2 if the paying bank did not have an agreement to send electronic returns (1) directly to the depository bank or (2) to a returning bank that is subject to the expeditious return requirement” would make it potentially advantageous for a paying bank to choose not to enter into electronic return agreements with depository banks or with a returning bank. The advantage would be that the paying bank would avoid being subject to the expeditious return requirement. The proposal argues that the cost of returning items in paper form would be enough to dissuade paying banks from choosing paper, even with the potential advantage of avoiding the expeditious return requirement, but in a low volume environment, the cost of paper returns may not be significant. At a minimum, proposed Alternative 2 would not create any new incentive for paying banks to move from paper to electronic return processing. The proposed rule might create a better balance of incentives if it imposed a two day expeditious return requirement on all paying banks but deprived the bank of first deposit, if it does not agree to accept electronic returns in a generally accepted manner from the paying bank or from a returning bank, of the ability to assert a claim against a paying bank or returning bank that fails to meet the expeditious return requirement.

The RPO believes that the requirement that a paying bank provide a bank of first deposit with a notice of non-payment should be retained when a paying bank returns paper. We are less certain whether the Board should retain the return notification requirement when the bank of first

deposit accepts only paper returns. Return notifications should, and probably do, have the marginal effect of reducing losses to the banking system. The Reserve Banks, which are not subject to a legal requirement to provide return notifications, nevertheless do provide large dollar return notifications with respect to returns over \$10,000 if the return is mailed to the bank of first deposit. On the other hand, retaining the requirement that the paying bank provide a notice of nonpayment lessens the incentive for a bank of first deposit to move from paper to electronic return receipt.

The Board asked about the extent to which there are paying banks that do not have agreements to send electronic returned checks. While there are very few remaining paying banks that lack the operational ability to send electronic returned checks, there are situations when an item is in some condition (e.g. mutilated) where a check cannot be imaged and must be sent as paper to an electronic receiver. The proposal covers a paper receiver but may need something to consider a depository bank that has appropriately agreed to be an electronic receiver either through a returning bank or directly from the paying bank, but then must receive a paper item from the paying bank because of some anomaly that cannot be addressed in an agreement for electronic returns. One possible solution might be the adoption of an electronic notice in lieu of return. On the question whether there should be a longer timeframe for receipt of a paper return item, the RPO recommends adding language into the rule such that a bank of first deposit that insists on receiving paper returns forfeits the protection of the expeditious return requirement, but a paying bank or returning bank is prohibited from adopting a return process that has the effect of slowing the return of an item in relation to the return process typically used by a similarly situated paying bank.

SUPPORT FOR ELECTRONIFICATION:

Electronic Checks, Electronic Returned Checks

The RPO supports the Board's effort to provide definition and support for images and data that are captured from paper checks and sent forward for collection. In general, what the Board is proposing to do in Regulation CC with respect to images and data captured from paper checks seems to be similar to what the Board did several years ago when it amended Regulation J to support image collection by the Reserve Banks. In Regulation J and under Operating Circular 3, a technically compliant record set that includes an image and data captured from a paper check and that is sent to a Reserve Bank for collection is an "electronic item," which has almost all of the legal characteristics of a paper check, except for some additional "Check 21 like" protections for the recipients of such electronic items. The RPO believes that the proposed amendment to Regulation CC accomplishes much the same purpose. However, it might be better if the Board would define an Electronic Check and an Electronic Returned Check so that the electronic record

would be effectively equivalent to a check only if the electronic record includes an image AND data captured from the paper check, rather than the proposed definition which defines an Electronic Check as an image OR data captured from a check. In the current environment, both the image and the data are important for transferees to receive, especially in complex use cases, such as instances in which the check names multiple payees, each of which must endorse the check before it can be properly negotiated. If the definition of an Electronic Check is revised to include both image AND data, banks can still agree to send only data, for example, under pre-existing law (See UCC 4-110 regarding electronic presentment notices.). Since the practical effect of a final amendment to Regulation CC is going to be that banks will be enabled to transfer electronic checks and electronic checks without image exchange agreements, we strongly believe that the Regulation should define Electronic Checks and Electronic Returned Checks in a way that provides the transferee bank a complete data set—image plus data, as long as the final Regulation also provides banks the option to exchange only data by agreement.

Electronically Created Items

It is widely known that electronic images and data that were not captured from paper checks are currently “riding the check rails.” Currently, Operating Circular 3 responds to these “non-checks” by imposing a warranty and an indemnity on a sending bank when it sends an image and data to a Reserve Bank for collection. The sending bank warrants that the image and data were captured from a check and indemnifies the Reserve Banks against any loss that results if the warranty is breached.

We agree with the Board’s apparent belief that Regulation CC needs to be amended to address the “non-check” phenomenon, but the RPO is concerned about the approach that the Board has taken to address the issue. Under the Board’s proposed amendment, a bank that transfers an “Electronically Created Item” to another bank for value would not make any of the traditional transfer or presentment warranties, or any other warranties, but would simply indemnify all subsequent transferee banks against any loss resulting from the fact that the Electronically Created Item was not captured from a check. In our view, this approach will enable Electronically Created Items to “ride the rails” between the banks while imposing both uncertainty, transaction costs, and risk on parties other than the creator of the Electronically Created Item or the bank that introduces the item into the check clearing system. In our view, a bank that transfers an Electronically Created Item should indemnify all transferees against any risk of loss, but should also make at least the following warranties with respect to the Electronically Created Item: *a)* that the item was issued by a person authorized to write checks against the account on which the item is drawn, *b)* that the bank is an institution authorized to send the Electronically Created Item forward for collection, *c)* that the item bears an authentic and authorized electronic signature, *d)* that the Electronically Created Item has not been altered since issuance, *e)* and that any encoding that has occurred since issuance is accurate. The sending

bank should also make the typical post-Check 21 warranty against duplicate payment. We are particularly concerned that all electronically created payment orders that might be used to debit consumer accounts should be required to bear an authorized and authentic signature from the point of issuance onward. While Regulation CC cannot directly impose that requirement, Regulation CC can require banks to warrant that this requirement has been met with respect to any item that “rides the check rails” between banks. Ultimately, we believe that the risk allocation under Regulation CC with respect to Electronically Created Items should be close to the risk allocation that the Board has created with respect to Remotely Created Checks, with respect to which the bank of first deposit bears the risk that the payment order was not properly authorized.

Duplicate presentments involving items that have been remotely deposited

The RPO supports the Board’s proposal to address the risks that are created when a bank of first deposit accepts an item from its depositor via remote deposit capture and the original check is deposited into another bank of first deposit. Under the Board’s proposal, a bank of first deposit that accepts an item via remote deposit becomes liable if the original check is subsequently deposited in another bank and presented to the paying bank. We do not agree with the view that has been adopted by some in the industry that whoever holds the original paper check can sue on the check as a holder in due course. We think that once the electronic item has been presented and paid by the drawer’s bank, the applicable legal doctrine is that of accord and satisfaction, and that a party that comes into possession of the original paper check does not possess all of the rights of a holder in due course on a negotiable instrument. If the transferee of an original check were to have holder in due course rights as against the drawer of that check when the check has been paid upon presentment of an image or a substitute check, then the drawer would be liable to the holder in due course and would have no defense against the holder’s lawsuit demanding payment of the original item. Therefore, we believe that the Board’s proposed solution is both necessary and appropriate. If the “second bank of first deposit” and its transferees are not protected by holder in due course status (which is clearly a bad outcome, as we have argued above), then the “second bank of first deposit” and its transferees will need to be protected against the risk that the original paper check they have accepted may have been remotely deposited at a “first bank of first deposit.” The Board’s proposed indemnity appropriately imposes the risk on the “first bank of first deposit” which accepts an image deposit without controlling the disposition of the original check.

Definition of MICR line – 229.2(vv)

Defining the “MICR line” on a check is relatively easy and the definition has been in place for some time. An Electronic Item or Electronic Return, however, does not have a “MICR line” per se but, rather has the data records that accompany the image in the generally accepted industry

standard, or another standard as agreed to by the parties exchanging electronic items or returns. The RPO suggests that the definition of MICR line be expanded to include “the data contained in the records or fields that are specified in the industry standard as the records or fields that contain the MICR data from the original check.”

The proposed language suggests that the Board would alter the industry standard by “rule or order”. This seems problematic. Would the Board use a notice and comment process to move from one iteration of the standard to the successor version? It is noteworthy that the ANSI process does not provide for a phased in adoption period for its standards. When an updated version of a standard is adopted by ANSI, the previous version is automatically and immediately superseded. Is there a reason why the Board would want to supersede the Standard process and the industry practice of adopting and implementing new versions of the standard by agreement? The RPO believes that the new definitions of MICR line, Electronic Check, Electronic Returned Check, and Electronically Created Item should be tied to a “generally accepted industry standard for exchanging images and data captured from checks, as amended from time to time”, rather than using the specific common standard of the day (x9.100.187).

Definition of Copy and Sufficient Copy – 229.2(bbb)

Currently, the definition of “copy” in Regulation CC is limited to paper reproductions of checks. In the current proposal, the Board is proposing to expand the definition of “copy” to include an electronic reproduction of a check that a recipient has agreed to receive from the sender instead of receiving a paper reproduction. The RPO supports this proposed change.

Not Currently Included - Definition of Electronically Created Item

The Board may want to consider formally defining an Electronically-Created Item as an image and data in the industry standard format for Electronic Checks, transferred for value, but not captured from a payment order that was originally issued in the form of a check.

Same-Day Settlement

The RPO believes that the industry has moved very efficiently from paper to electronic collection and return, without imposing an electronic Same Day Settlement Rule. Unless the industry were to develop a consensus that an Electronic Same Day Settlement Rule would create greater efficiency or would solve a problem of competitive inequality, we see no reason to import the paper Same Day Settlement Rule into the world of electronic presentment. In our view, even retaining the paper Same Day Settlement Rule has become a questionable policy, if it creates any incentive for a presenting bank to present paper same day settlement items to a paying bank rather than sending electronic items for collection.

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The RPO appreciates the amount of effort that the Board has put into the proposed amendment to Regulation CC. In general, we are very supportive of the direction that the proposed amendment is taking. We appreciate the opportunity to comment on the proposed changes and we hope that our suggestions are useful.

Sincerely,

A handwritten signature in cursive script that reads "Marie Gooding".

Marie C. Gooding
First Vice President
Director, Retail Payments Product Office