

VIA E-MAIL

March 12, 2004

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: **Regulation CC; Docket R-1176**
Availability of Funds and Collection of Checks

Dear Ms. Johnson:

On behalf of NACHA—The Electronic Payments Association¹, I respectfully submit this response to the Federal Reserve Board (“FRB”) on its proposal to implement the provisions of the recently enacted *Check Clearing for the 21st Century Act* (“Check21 Act”) as amendments to Regulation CC. Our response supplements a joint financial services industry response (“Industry Response”) that NACHA has signed and focuses on matters related to the Automated Clearing House Network (“ACH Network”) and to remotely-created drafts.

ISSUE 1: Definition of “Substitute Check” at Proposed Section 229.2(zz)

The FRB’s proposed definition of a “substitute check” in Section 229.2(zz) and the related Commentary have potential implications to how the Check21 Act and the changes to Regulation CC are interpreted with respect to certain ACH Network applications. These applications can be broken down into three categories:

1. ACH Entries Where Check is Truncated
2. ACH Entries Where Check is Eligible and Conversion is Authorized
3. ACH Entries Where Check is Ineligible or Conversion is Unauthorized

The Commentary to Section 229.2(zz) of the Proposal states that “[B]ecause a substitute check must be a representation of an item that is defined as a check under Section 229.2(k), a paper reproduction of an image of something that is not a check cannot be a substitute check.” While NACHA agrees with the FRB’s approach in the proposed Commentary, we believe further clarification is necessary with respect to each of the three categories identified above. Such clarification would be of great benefit to consumers, businesses and the payments industry.

¹ **About NACHA—The Electronic Payments Association:** NACHA is the leading organization in developing electronic solutions to improve the payments system. NACHA represents more than 12,000 financial institutions through direct memberships and a network of regional payments associations, and over 650 organizations through its industry councils. NACHA develops operating rules and business practices for the ACH Network and for electronic payments in the areas of Internet commerce, electronic bill payment and presentment (EBPP), financial electronic data interchange (EDI), international payments, electronic checks, and electronic benefits transfer (EBT). Visit NACHA on the Internet at: www.nacha.org.

1. ACH Entries Where Check is “Truncated:” The ACH Network supports several applications where a check is truncated and used to initiate an ACH debit – i.e., Re-presented Check Entries (RCK), Destroyed Check Entries (XCK), and Check Truncation Entries (TRC or TRX). The “check” in each of these applications is negotiated in accordance with the Uniform Commercial Code Articles 3 and 4 (“UCC 3&4”).

NACHA Interpretation for Commentary: We believe that the check used in these applications is covered by Regulation CC, and the resulting ACH entry is covered by the NACHA Operating Rules and other relevant law or agreements. Consequently, the original check can be converted to a substitute check at any point up to the point of truncation, and an ACH debit can be initiated from the substitute check. Further, if the ACH debit is returned, the original check or a substitute thereof may be used to collect the underlying debt.

2. ACH Entries Where Check is Eligible and Conversion is Authorized: The ACH Network also supports applications where a check is used as a “source document” as part of the EFT authorization process – i.e., Accounts Receivable Entries (ARC) and Point of Purchase Entries (POP).

NACHA Interpretation for Commentary: In neither of these applications is the original check ever negotiated under the terms of UCC 3&4 and as such these applications should lie fully outside the scope of Regulation CC (they are covered by Regulation E).

3. ACH Entries Where Check is Ineligible or Conversion is Unauthorized: There are circumstances when an ARC or POP entry is intended, but the check provided was either: (1) a type of check identified as ineligible as a source document under NACHA Operating Rule 3.6.2 (for ARC Entries) or 3.7.1 (for POP Entries);² or (2) the merchant or biller has in some way failed to obtain proper authorization for the transaction. In either circumstance, a payment obligation is incurred, but the NACHA Operating Rules prevent the payment from being collected as an ACH debit.

NACHA Interpretation for Commentary: Since the check used for either application is ineligible under the NACHA Operating Rules as a source document, or its conversion has not been properly authorized, we believe the check has been negotiated under the terms of UCC 3&4 and therefore can be converted to a substitute check.

NACHA further contends that this scenario exists whether the merchant or biller determines the check’s ineligibility as a source document for an ARC or POP entry at the point of acceptance, or if the entry has been inadvertently originated and subsequently returned due to its ineligibility. In the latter

² Examples of ineligible source documents (2004 NACHA Operating Rules): checks drawn on corporate or business accounts, third-party checks, unsigned demand drafts, credit card checks, obligations of a financial institution (e.g., travelers checks, cashier checks, official checks, money orders, etc.), government checks and non-U.S. dollar-denominated checks.

circumstance, NACHA believes that the merchant or biller would have the right, upon learning of the original check's ineligibility as a source document, to rely on either the original check or the creation of a properly authorized demand draft (e.g., if the original check is unavailable), either of which could be converted to a substitute check, to collect the underlying debt.³

ISSUE 2: Substitute Check Warranties in Section 229.52(a)

Section 5(2) of the Check 21 Act creates a warranty against presenting both the original check and a substitute of the original check to collect one underlying payment. The FRB seeks comment on its proposed Section 229.52(a) implementing that provision in the Act as to whether the duplicate payment warranty should apply to "an ACH debit that was created using information from an original check or substitute check."

NACHA believes very strongly that the warranty in Section 229.52(a) should NOT apply to a duplicate payment resulting from an ACH debit – a view also expressed in the Industry Response. ACH entries lie fully outside laws specific to checks and check collection and are governed by a combination of the FRB's Regulation E and the NACHA Operating Rules. Moreover, the NACHA Operating Rules provide ample protection with respect to a duplicate payment involving an ACH entry related to a check. First, the NACHA Operating Rules already contain a comparable warranty with respect to the ACH entry that the original check (which would include its substitute) will not be presented. Second, the NACHA Operating Rules require prompt recrediting of the Receiver's account if the ACH entry and the "item" (i.e., the original check or its substitute) or source document are both presented for payment.⁴

ISSUE 3: Remotely-Created Demand Drafts

The FRB seeks comment on whether to incorporate into Regulation CC the latest NCCUSL amendments to UCC 3&4 relating to "remotely-created demand drafts" (also known as "demand drafts" or "pre-authorized drafts"). In summary, the amendments to UCC 3&4 would establish a new transfer and presentment warranty for remotely created demand drafts whereby the transferor warrants that "the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn."

NACHA's understanding from its members, and from discussions with Federal agencies and law enforcement, is that unauthorized demand drafts are being used extensively to commit fraud against consumers and businesses. Demand drafts saddle paying banks with significant costs and customer service issues when the authorization is in dispute and has to be researched. Moreover, collecting on an unauthorized demand draft is difficult for the payor and paying bank since the item almost certainly

³ With respect to reliance on a demand draft, this assumes the merchant or biller has obtained proper authorization and otherwise meets the requirements of UCC 3&4 and Regulation CC.

⁴ NACHA Operating Rule 7.6.2 for POP, 7.6.3 for RCK and 7.6.4 for ARC entries.

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is not discovered until after the midnight deadline for its return has passed.

For these reasons, NACHA strongly supports adding an authorization warranty for demand drafts to Regulation CC since this would clarify where the responsibility for obtaining proper authorization lies and which party(ies) would be accountable in the event of a disputed authorization. Moreover, by adopting such a warranty under Regulation CC, which we believe the FRB has the authority to do, the warranty would apply uniformly across the Nation's check collection mechanism, regardless of state or means of collection.

We also support the request in the Industry Response that the final rule on this matter apply this warranty to all demand drafts, not just demand drafts that are drawn against consumer accounts. We see no basis for distinguishing between consumer and non-consumer accounts in this regard. Finally, we too would recommend that the warranty under Regulation CC warrant that the item is authorized according to all the terms of the item, not just the amount of the item.

The Industry Response seeks a separate proposal and request for comment from the FRB on adopting this new warranty under Regulation CC. NACHA believes the prompt issuance of such a proposal will stimulate industry efforts to develop efficient means to pursue and collect on warranty violations on behalf of accountholders.

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NACHA appreciates the opportunity to comment on this proposal. If you have any questions regarding our comments, I may be reached at (703) 561-3929, or by e-mail at *imacoy@nacha.org*.

Sincerely,

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