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By Email and First Class U.S. Mail

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

Reference: Regulation CC-Docket No. R-1226

Dear Ms. Johnson:

I. Background

The Western Payments Alliance¹ (“WesPay”) is pleased that the Federal Reserve has proposed to address the issue of Remotely Created Checks (RCCs), also known as Demand Drafts under WesPay rules and within the Uniform Commercial Code of the states in its territory, including California, Hawaii, Idaho, Nevada (currently in its legislature), Oregon and Utah.

While there are legitimate uses of RCCs, in 1995 WesPay and the California Bankers Clearing House Association (BCH subsequently merged into WesPay in January 2001) were alerted that unsigned drafts were being fraudulently used to debit consumer accounts. Using its authority to promulgate clearing house rules², WesPay adopted a new rule that shifted the liability for such items back to the depository bank (the term “bank” in this response includes banks, credit unions and savings and loan institutions), under the notion that the depository bank (charged with knowledge of its customer³) is in the best position to avoid the introduction into the check

¹ The Western Payments Alliance (“WesPay”) is a not-for-profit financial trade association providing electronic fund transfer services to nearly 1,000 financial institutions and 120 corporate members in California, Hawaii, Idaho, Nevada, Oregon, Utah, Southern counties of Washington, Guam and other Pacific territories. WesPay consults with its members on the application and interpretation of Automated Clearing House (ACH) operating Rules and provides a variety of workshops and seminars designed to increase member knowledge on ACH and other payment systems processes, enhance rule compliance and mitigate risk.

² Uniform Commercial Code (“UCC”) § 4104 (b)

³ 31 U.S.C. § 5318(l).

collection process of an unauthorized demand draft by scrutinizing its customers permitted to deposit those drafts.

Demand draft fraud was clearly becoming an issue and not just in the WesPay service area. For instance, on April 15, 1996, demand draft fraud was the subject of the Federal Trade Commission's ("FTC") testimony before the House Banking Committee by Ms Jodie Bernstein⁴, director of the Bureau of Consumer Protection, noting that the "unauthorized debiting of a consumer's checking account is a growing problem." She also stated that "The Telemarketing Sales Rule prohibits the use of demand drafts in a telemarketing transaction without a consumer's express verifiable authorization..." and such "authorization may be obtained by any one of three methods: (1) written authorization; (2) tape recording; or (3) written confirmation notices sent to a consumer before the demand draft is submitted for payment."

In 1996, the California legislature enacted a new law⁵ that revised UCC 3 and 4 using the WesPay rules as a model, including adding the definition of a demand draft and a warranty applicable to both corporate and consumer accounts, and shifting the warranty to the depository bank. We believe that sixteen other states have followed California's lead and enacted identical or comparable legislation.⁶ We understand that Minnesota has adopted the NCCUSL⁷ version, but not in its entirety, expanding the definition to include corporate accounts. Check clearing houses have also adopted or proposed rules modeled on California legislation.⁸

WesPay supported the notion of adding a RCC warranty in the Request for Comment addressing Check 21⁹. We stressed the need to have national uniformity for RCCs and applauded the Board for identifying it as an issue.

⁴ Prepared Statement of the Federal Trade Commission, "Demand Draft Fraud" presented by Jodie Bernstein before the House Banking Committee, April 15, 1996; <http://www.ftc.gov/speeches/other/ddraft.htm>

⁵ S.B. 1742, Chapter 316 (1996).

⁶ The following sixteen states have adopted legislation modeled on California's demand draft law:

Colorado	Hawaii	Idaho	Iowa
Maine	Missouri	Nebraska	New Hampshire
North Dakota	Oregon	Tennessee	Texas
Utah	Vermont	West Virginia	Wisconsin

⁷ National Conference of Commissioners on Uniform State Laws ("NCCUSL") www.nccusl.org. NCCUSL uses the following definition: "Remotely created consumer item" means an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer.

⁸ E.g., see Uniform Rules for Paper Check Exchange, Rule 8, draft of January 31, 2005, as issued by The Clearing House Payments Company L.L.C.

⁹ Regulation CC; Docket R-1176 - Availability of Funds and Collection of Checks

We continue to believe that the check system is not well served by waiting for each state to revise its UCC. We support the Board Proposal generally, and believe it has the authority under the Expedited Funds Availability Act¹⁰ to include RCCs in Regulation CC. In doing so, uncertainty for RCCs will be eliminated for financial institutions and their customers.

II. Summary of WesPay Positions and Recommendations

WesPay has worked with several industry groups including the California Bankers Association, Electronic Check Clearing House Organization (“ECCHO”), and NACHA - The Electronic Payments Association and has had discussions with individuals from the WesPay membership. We believe that the following is a consensus of the WesPay membership developed through those deliberations; however it may not reflect the views of each WesPay member financial institution.

A. Application of the Remotely Created Check Warranty

WesPay agrees that the current Proposal to include business accounts is appropriate and consistent with every state UCC within WesPay’s region (California, Hawaii, Idaho, Nevada, Oregon and Utah). While we believe that most of the RCCs are consumer drafts, it is reasonable for the depository bank to deter abuses of both consumer and corporate items.

B. Remotely Created Check Definition

We believe that the RCC definition in the Proposal should be revised for two reasons:

1. The definition of RCC requires that the RCC be “created by the payee.” The Commentary to the definition states that a RCC created by an agent of a payee would be deemed to have been created by the payee for purposes of this definition. That definition could introduce two uncertainties as to the application of the warranty.

- First, it is not clear how a paying bank could determine from examining the RCC, or from even contacting its drawer customer, whether a particular RCC was created by the payee or its agent and could result in disputes between the paying bank and the depository bank as to whether the RCC warranty was potentially applicable to the RCC.

¹⁰ Pub. L. 100-86, 101 Stat. 635 (codified at 12 U.S.C. § 4001, et seq.).

- Second, there are some RCCs that are created by persons other than the payee or the payee's agent. In the bill payment context, a customer may contract with a third party bill payment company to provide the customer with bill payment services. Some of these bill payment services complete the bill payment by printing a RCC made payable to the payee, and sending it to the payee for payment of the customer's bill. In that situation, the RCC is created by the customer's agent, not the payee's agent. We believe that it is appropriate to have the same RCC warranty protection apply to this type of RCC as apply to a RCC that is created by the payee.

The above recommendation is consistent with the approach taken in the recent revisions to UCC Article 3 (the "UCC Revisions") to address RCCs under the UCC. The UCC Revisions define a "remotely-created consumer item" as an item "which is *not created by the payor bank* and does not bear the handwritten signature purporting to be the signature of the drawer." (Emphasis added).¹¹

2. Signature of the Payee

The current definition of RCC in the Proposal states that a RCC does not "bear a signature in the format agreed to by the paying bank and the customer." We recommend that the Federal Reserve consider revising this signature element of the definition. We support an approach consistent with the UCC Revisions. The UCC Revisions define a "remotely-created consumer item" as an item "which is not created by the payor bank and *does not bear the handwritten signature purporting to be the signature of the drawer.*" (Emphasis added). We believe that this approach to excluding signed items from the definition of RCC more clearly delineates between a RCC subject to the proposed new warranty and a check containing a fraudulent or unauthorized signature of the customer which is not subject to the RCC warranty.

As a related matter, we recommend that the definition under the Proposal not include a requirement that the signature of the customer be "handwritten" as is required in the analogous definition in the UCC Revisions. Since the RCC warranty in the Proposal should extend to business RCCs, it is appropriate to include within the definition of RCCs those items that have neither a handwritten or a facsimile signature.

¹¹ This recommended approach also is consistent with California's definition of "demand draft," which is a "writing not signed by a customer that is *created by a third party* under the purported authority of the customer for the purpose of charging the customer's account with a bank." Cal. Commercial Code, Section 3104(k).

Therefore, we recommend the following definition that has been developed by the membership of ECCHO and other financial institution trade groups (but with a recommendation that the Board clarify that Payable Through Checks are included within this definition):

Section 229.2(fff): “Remotely created check” means a check that is drawn on a customer account at a bank, is not created by the paying bank, and does not bear a signature purporting to be the signature of in the format agreed to by the paying bank and the customer.

The Proposal does not specifically address whether or not the definition of RCC is intended to include those checks that are payable-through a bank and drawn on another bank or a non-bank payor. It is unclear that the current Proposal RCC definition covers payable-through checks. This is because it is not clear whether for purposes of this definition a payable-through check is “drawn on a customer account at a bank” and because payable-through checks generally do not bear the signature of the drawer. The state demand draft laws within the WesPay region also do not specifically address payable-through checks.

We believe that the payable-through checks should come within the definition of an “RCC,” and should have the benefits of the RCC warranty. The bank/non-bank payor cannot review a customer signature on such checks, and therefore the payor should have recourse to banks that transferred the check to it. We recommend that the Federal Reserve revise either the definition of a RCC or the related Commentary, in a manner consistent with the revisions proposed in this letter, to include checks payable-through a bank as within the definition of an “RCC.”

3. Alternative Approach on Definition of Remotely Created Check

In the event the Board adopts a definition dissimilar to the substance of the above recommended revisions to the Proposal’s RCC definition, WesPay urges the Board to consider revising the definition in the final rule to be consistent with the definition of “demand draft” under the laws of California and other states (sixteen states that have already adopted the California model demand draft legislation, including five other states in the WesPay region) that have adopted an authorization warranty for these type of items under their UCCs. This is a definition that has

been in effect in California since 1996 and has not surfaced any unique issue or controversy.¹² It has been tested by the passage of time.

We believe that the Board should confirm that remotely created checks (or remotely created items, under the NCCUSL recommendation) are substantially similar to demand drafts as a matter of law, so that two differing instruments do not come into play in the marketplace.

This approach to the definition of RCC in the final rule would provide a consistent statutory definition for these types of items under federal and state law.

C. Definition of Account.

We request that the Federal Reserve consider providing additional Commentary to Section 229.2(ff) regarding the term “customer account” as used in the definition of Remotely Created Check. The Commentary should state that the term “customer account” for these purposes includes accounts other than a traditional checking account, such as the following types of accounts on which RCCs could be drawn: (i) any customer asset account at a bank, (ii) customer credit accounts, and (iii) the bank’s own accounts, such as accounts used by the bank to pay official checks and teller’s checks. We believe that the commentary is necessary to ensure that the RCC warranty applies to the full range of possible RCCs.

¹² The California Commercial Code “demand draft” definition may raise the following issues:

- The demand draft must be created by a third party. Presumably, that third party is not the paying bank or its customer. Consequently, if the paying bank creates a draft in favor of a creditor of its customer at the request of its customer in connection with the delivery of a bill payment service, that instrument would not be a demand draft or remotely created check. While such an instrument may not be covered by the Proposal, the underlying policy consideration therefore does not come into play. The warranty applicable to remotely created checks is necessary because the depository bank is in a better position than the paying bank in identifying wrongdoing; the depository bank is expected to know its customer. However, in the case of the draft created by a paying bank in favor of its customer, the paying bank is in a better position than the depository bank to have knowledge thereof. There is no compelling reason to have the remotely created check warranty apply under such circumstances.
- Similarly, if the customer of the paying bank uses a vendor to create drafts on behalf of the customer in connection with, e.g., a bill payment service, drafts created by a vendor would not come within the purview of the Proposal. The vendor is acting as an agent of the customer; thus, that vendor would not be a third party for purposes of the proposed definition, strictly speaking, however, the policy consideration applicable to remotely created checks would not come into play. The customer is in a better position to have knowledge about the draft than the depository bank.
- A demand draft may not fall within the purview of UCC § 4406 with regard to the duty of a customer to report unauthorized signatures, because a demand draft, by definition, lacks a signature. Thus, even if the Board were to adopt a new definition for remotely created checks using the definition for demand drafts, we urge the Board through comment to provide that customers have a duty to report unauthorized remotely created checks under UCC § 4406, even if such checks by definition do not bear signatures.

D. Warranty for Remotely Created Checks

1. Scope of Warranty.

WesPay recommends that the definition of RCCs be revised to state that a RCC must be authorized by the customer according to the terms stated “on the face” of the check. We believe that limiting the authorization to the terms “on the face” of the check more clearly delineates the scope of the RCC warranty.

2. Situations Not Covered under Warranty

We believe that the warranty should **not** apply:

- to a claim by the customer that a RCC was unauthorized because the agreed payment period varies from the date on the RCC or from the date of actual payment of the RCC by the paying bank or,
- to a situation in which the customer has sought to refuse payment of a RCC because of buyer’s remorse, where the RCC is otherwise authorized according to the terms on the face of the RCC.

Accordingly, WesPay recommends that the Proposal clarify the above situations with the following Commentary Text:

Section 229.34(d)-# A Remotely Created Check is not unauthorized for purposes of the RCC warranty in situations where the paying bank has recredited its customer’s account for a RCC because: (i) the date on the RCC was inconsistent with either the date agreed to by the customer and the payee for payment of the goods or services or the date agreed for the issuance of the RCC; or (ii) the customer alleged that the goods or services provided were not consistent with the terms of the purchase or otherwise has a dispute with the merchant regarding the goods or services.

3. Defenses of Transferring Bank to Warranty Claim

Under the UCC, when a breach of warranty claim is made by the paying bank under UCC § 4208, the warrantor (usually the depository bank) may defend the claim “by proving that the indorsement is effective under Sections 3404 or 3405 or the drawer is precluded under Sections 3406 or 4406 from asserting against the drawee the unauthorized indorsement or alteration.”

Comment 6 to UCC § 3417 explains the purpose of this provision:

If the drawer’s conduct contributed to a loss from forgery or alteration, the drawee should not be allowed to shift the loss from the drawer to the warrantor.

We believe that the depository bank should be able to assert defenses in the event the paying bank enjoys defenses against the drawer under the UCC.

E. Alternatives to Remotely Created Check Warranty

1. Proposal to extend the Midnight Deadline.

While extending the midnight deadline may assist in the timely resolution of breach of warranty claims with regard to RCCs, we do not support the extension of the midnight deadline.

Extending the midnight deadline will foster greater uncertainty about the check system generally, potentially raising finality of payment issues and subsequent unanticipated results.

It is possible that a bank may not learn of an unauthorized RCC for several months from the date of payment. The RCC warranty provides protection up to one year for the paying bank. As mature as the check collection system and its related regulations, rules and laws are, we believe that extending the return deadline for unauthorized RCCs could disrupt existing practices and decisions for checks in general.

We recognize that there may be some support in the industry for a process to handle these RCC warranty claims, which are typically small dollar amounts, on a settlement entry basis. However, we do not support extending the midnight deadline in order to allow these warranty claims to be handled as returns in the settlement process. Rather, we support the development of procedures under clearing house rules and Federal Reserve Banks Operating Circular 3 that would allow all or some of these RCC warranty claims to be handled as claims but through adjustment processes and “with entry”. One example of how to accomplish this is Rule 8 of the Uniform Paper Check Exchange Rules.¹³

2. Proposal to defer waiting for states to adopt UCC revisions.

WesPay does not support waiting for additional states to adopt UCC revisions related to this issue. Every state in WesPay’s region has already adopted Demand Draft legislation and those financial institutions may be at risk from fraudsters depositing RCCs in states that have not addressed this serious issue. The California revisions have been time tested, adopted by contiguous states and used for the NCCUSL model language.

¹³ Rule 8 is based on a consolidation of WesPay rule 4.8.1, Warranties and 6.3.9, Unauthorized Debit. WesPay rules were licensed to The Clearing House Company L.L.C. as part of the agreement to transfer the WesPay Check Clearing services to TCH on January 2, 2004 and have subsequently been revised. Under Rule 8, a paying bank may make a warranty claim against a depository bank for an unauthorized remotely-created check. Rule 8 states that the paying bank “may make a warranty claim” by “delivering such check to the clearinghouse or the depository bank for settlement, in accordance with the clearinghouse’s rules for returned checks.” While the claim is processed through the return settlement process, the delivery of the check to the clearinghouse, and ultimately the depository bank, is not a “return” of the check under the UCC or Regulation CC.

F. MICR Line Identification of Remotely Created Checks

WesPay does not believe that such items should be identified by a special code in Position 44 of the MICR line for legal and practical reasons.

G. General Characteristics of Remotely Created Checks

There are many examples of legitimate uses of RCCs, including telemarketing and bill payment transactions and non-acceptance or inability to receive ACH entries. In some situations, companies do not have the capability to create ACH transactions but they are able to create RCCs. In some situations, a RCC may clear faster than an ACH transaction.

The earliest adopters of RCCs were insurance companies for recurring, preauthorized monthly premium payments. In recent years, some bill payment services move money directly from the customer's account to a merchant's account by creating a RCC drawn on the customer's account and payable to the merchant.

It is our belief that RCC applications provide an additional legitimate payment solution that financial institutions can continue marketing to their customers, albeit at the risk of warranty claims for unauthorized RCCs.

WesPay does not have any data on the annual number of RCC transactions. We presume that the volume is not significant compared to total check volume and that most RCCs are for low dollar amounts because of the nature of the applications. The Federal Reserve may wish to sample such items in its next payments survey of checks and ACH.

H. Implementation Period for Final Rule.

While the Board did not specifically solicit this comment, we urge the Board to grant at least a six-month period to implement any new change to Regulation CC concerning RCCs. This period will afford financial institutions an opportunity to change deposit agreements, policies, procedures, and check processing systems, and train employees and educate customers. This transition period would be especially valuable for financial institutions doing business in states not having adopted demand draft or remotely created item legislation since they have no experience dealing with such instruments, unless clearing house rules govern.

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III Conclusion

WesPay expresses its appreciation for the opportunity to comment on this important proposal. We believe that national regulatory and legal uniformity is essential to protect financial institutions, consumers and corporations from abuses, yet allow legitimate uses of RCCSs.

Sincerely,

Peter Yeatrakas
President and CEO
Western Payments Alliance