

EastPay, Inc.
7400 Beaufont Springs Dr
Suite 405
Richmond, VA 23225
804-644-1642

VIA E-MAIL

May 3, 2005

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

**Re: Docket No. R-1226
Proposal to Impose Authorization Warranty on Depository Bank for
Remotely Created Checks**

Dear Ms. Johnson:

On behalf of EastPay, an electronic payments association representing over 650 financial institutions in VA, WV, NC and FL, I respectfully submit this response to the Federal Reserve Board's ("FRB") 'Proposal to Impose Authorization Warranty on Depository Bank for Remotely Created Checks'.

FRB PROPOSAL

The *Expedited Funds Availability Act* authorizes the FRB to establish rules regarding losses and liability among depository institutions "in connection with any aspect of the payment system." As noted, the check collection and return system operates nationally. As a result, in order for remotely created check warranties to be effective and to prevent conflicts among warranties as they apply to banks, the warranties must apply uniformly and nationwide. In connection with its proposed amendments to Regulation CC to implement the *Check Clearing for the 21st Century Act* (the Check 21 Act), the FRB requested comment on whether it should develop a proposal to amend Regulation CC to adopt the UCC warranties for remotely created checks [69 FR 1470, 1482, Jan. 8, 2004]. Seventy-six commenters responded to the FRB's request for comment on this issue. All but two supported the proposal, including NACHA, the industry and the Permanent UCC Editorial Board.

Issue 1 -- Coverage: The FRB's proposal defines "remotely created check" as "a check that is drawn on a customer account at a bank, is created by the payee, and does not bear a signature in the format agreed to by the paying bank and the customer." This definition would include checks that are created by remote payees or their agents to enable payors to make a payment by check. A remotely created check often contains a statement that the customer authorized the check, the customer's printed or typed name, or a similar notation. Generally, a paying bank and its customer agree to a form of authorization for checks drawn on the customer's account. These agreed-upon formats most often take the form of a handwritten signature or a specific type of machine-applied signature. The proposed definition covers remotely created checks that do not bear a signature in the format agreed to between the paying bank and its customer. Accordingly, a check that is created by someone other than the drawer and on which the drawer's signature is applied using the authorization format agreed to by the paying bank and its customer (such as a handwritten signature), is not a "remotely created check" under the proposal. For example, a typical forged check, such as a stolen personal check fraudulently signed by a person other than the drawer, is not covered by the proposed definition of a remotely created check. In this regard,

the FRB believes the existing system of warranties appears suitable for because the paying bank can monitor the format and the signatures it has agreed to with its customer.

Unlike the UCC amendments, the FRB's proposed definition would apply to remotely created checks drawn on consumer and non-consumer accounts. Although the FRB believes that most remotely created checks are drawn on consumer accounts, these checks could also be drawn on business or other accounts. In either case, the depository bank would appear in the best position to address the potential for fraudulent checks.

EastPay comments: EastPay agrees with the FRB's proposed definition of a remotely created check and supports extending coverage of an authorization warranty for remotely created checks to those drawn on any type of account, not just consumer accounts.

Issue 2 -- Proposed Warranty: The FRB proposes to create transfer and presentment warranties that would apply to remotely created checks that are transferred or presented by banks to other banks through the collection chain. Under the proposed warranties, any transferor bank, collecting bank, or presenting bank would warrant that the remotely created check that it is transferring or presenting is "authorized according to all of its terms by the person on whose account the check is drawn." The proposed warranties would apply only to banks and would ultimately shift liability for the loss created by an unauthorized remotely created check to the depository bank. A paying bank would not be able to assert a warranty claim under the FRB's proposed rule directly against a non-bank payee that created or transferred an unauthorized remotely created check. The proposed transfer and presentment warranties differ in this respect from the UCC provisions, which apply to any person that transfers a remotely created check. However, the depository bank would likely have a claim under other law against such a payee. The FRB's proposal also differs from the UCC provisions to the extent that the FRB's proposed warranties cover all of the terms of the check while the UCC provisions cover only authorization of the issuance of the check in the amount for which the check is drawn. The FRB is also proposing conforming cross-references to the proposed new warranties in Regulation J.

EastPay Comments: We also agree with the proposal in terms of coverage of all of the terms of the check, and the ultimate effect of shifting liability for a loss through the collection chain to the depository bank. EastPay also recognizes that the proposed limitation of the warranty structure to banks in the collection chain reflects the scope of the FRB's authority under Regulation CC.

Additional FRB Requests for Comment: The FRB is reviewing other approaches to address the risks associated with remotely created checks and invites comment on whether a different approach is more appropriate. In particular, the FRB requests comment on the following three approaches.

1. Extension of the Midnight Deadline

Under the proposal described above, a paying bank would recover its losses caused by an unauthorized remotely created check by making a warranty claim outside of the check collection and return system. As an alternative, the rule could potentially allow such a paying bank to return the unauthorized remotely created check through the check system by extending the UCC midnight deadline for a period of time (such as 60 days). Such a rule could reduce the cost of recovering losses suffered in paying unauthorized remotely created checks and, as the FRB notes, is similar to the return scheme for unauthorized ACH transactions. However, the rule would extend the midnight deadline considerably, and thereby delay finality of payment and discharge of the underlying obligation with respect to remotely created checks. Commenters that favor the

extension of the midnight deadline are encouraged to explain their preference for this approach, including how such an approach would be implemented under the current check collection process.

EastPay Comments: The proposal of an Extension of the Midnight Deadline for returning an unauthorized remotely created check through the check collection system should be seriously considered. Existing NACHA Operating Rules (which govern the ACH Network) provides a 60 day right of return for unauthorized consumer transactions and also provides authorization warranties that are comparable to the proposal by the FRB.

The existing ACH model offers excellent protection to the consumer. In the ACH Network, the Originating Depository Financial Institution (ODFI) warrants that all transactions that they initiate on behalf of their Originator are authorized. This model is can be compared directly to the FRB's proposal for remotely-created checks.

2. Allow the State Legislatures to Adopt the UCC Amendments

The FRB could refrain from or delay acting on the remotely created check issue and allow the states to adopt the UCC warranty, or some variation thereof, on their own. Check law traditionally has been the province of state law, although a substantial number of federal laws and regulations apply to the check collection system as well. The pace at which the states have adopted the UCC changes has been slow and that might be an indication that consensus has not been reached on whether there should be a change to the warranties for remotely created checks.

EastPay Comments: We believe that the FRB could delay acting on the remotely created check issue and defer to individual states adoption of the UCC warranty. We, however, believe that a consistent, nationwide structure would serve this issue better.

3. MICR Line Identifier

Regardless of whether the FRB provides a special warranty or return rule for remotely created checks, it may be useful to have a means of identifying these checks so that banks can better protect themselves and their customers against fraud. Identifying remotely created checks could be accomplished by assigning digits in the External Processing Code (EPC) Field (commonly referred to as Position 44) of the MICR line to remotely created checks. Four digits would appear to be necessary to identify a forward and return original remotely created check and a substitute check version.

However, the FRB has stated that the practical utility of a MICR line code for identifying fraudulent checks may be low in practice because a person depositing an unauthorized remotely created check would be unlikely to place an EPC identifier in the MICR line. Furthermore, requiring a payee, rather than a bank, to encode in position 44 of the MICR line may lead to inconsistent results and operational problems.

EastPay Comments: We believe that the FRB should research the use of position 44 of the MICR line to help minimize fraud. NACHA and other banking representatives have already begun to identify the benefits of the MICR line indicator. Although the benefit of its use has not yet been proved, further research seems to be appropriate.

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Thank you for the opportunity to comment. If you have any questions, please call me at 804-644-1642.

Sincerely,

Bradley W. Smith, AAP
Director of Network Services
EastPay, Inc.

cc: EastPay Board of Directors