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

RE: Docket No. R-1176

Dear Jennifer:

The Federal Reserve's Retail Payments Office ("RPO") is pleased to offer the following comments on the proposed amendment to Regulation CC to implement the Check Clearing for the 21st Century Act ("Check 21"). The Retail Payments Office strongly supports the purposes of the Check 21 Act and the proposed amendment to Regulation CC. The final result of the transition from paper check clearing to electronic check clearing will be a more efficient payment system, and Check 21 is an important step in removing existing legal barriers to this transition. We would, however, like to offer some further comments.

The Check 21 legislation and its implementing regulation is a huge change for the industry and, thus, clarity needs to be a key focus. We have noted a few areas that may warrant further review as it pertains to greater clarity. The first example relates to the legal status of a document that is transferred for value, and bears the legend "This is a substitute check..." but fails one of the tests for legal equivalency set forth in Check 21. The proposed regulation attempts to clarify the potential confusion in the statutory language by setting forth the principle that a document that "purports to be a substitute check," but fails one of the statutory tests is a substitute check for purposes of the proposed warranty, indemnity, and recredit provisions of Regulation CC. We would encourage the Board to be clear about the circumstances under which a document would "purport to be a substitute check."

A second example of language in the statute and the regulation that may lead to confusion is the phrase "a paper or electronic representation of a substitute check." The Check 21 warranties and indemnities travel with a substitute check and with "a paper or electronic representation of a substitute check." It is not clear whether this language would include, for example, an image derived from a substitute check, even if a bank that sent such an image clearly labeled it as "Non-Negotiable." If a bank were to include such an image, clearly labeled as a "copy," in a

request for an adjustment pursuant to sections 12 and 18 of Reserve Bank Operating Circular 3, would the bank be making itself subject to the Check 21 warranties and indemnities? It seems essential that the final amendment to Regulation CC make it clear to depository institutions when a document is deemed a “negotiable instrument,” and what action a bank needs to take related to operational issues, to create and transfer a derivative of a substitute check that does not carry the Check 21 warranties and indemnities.

It is often difficult to determine the appropriate placement of clarifying language. In some cases it works better in the regulation itself. The statute requires that to be the legal equivalent of an original check, a substitute check must include all the information. The statute requires all of the information from the front and the back of the original check at the time the original check is truncated. The Board has specified the meaning of the words “all the information” by including in the commentary a list of “the information that must be accurately represented” in the substitute check. The commentary goes on to say that “a substitute check need not capture other characteristics of the check, such as watermarks, microprinting, or other physical security features that cannot survive the imaging process... in order to meet the accuracy requirement.” There are important policy considerations in play, since the entire purpose of the statute was to facilitate imaging and electronic exchange, and this purpose would be defeated if a substitute check had to include information that cannot survive the imaging process. The RPO suggests the Board write language in the regulation itself that expressly limits the meaning of the statutory phrase “all the information” and do so expressly under the Board’s authority to “prescribe such regulations as ...necessary to implement, prevent circumvention or evasion of, or facilitate compliance with the provisions of this Act.”

Section 229.52(b) departs from the text of the statute by clarifying that the Check 21 warranties run “forward” with the substitute check and its derivatives but not “backward” to parties that handled the original check. This clarification may lead to unintentional outcomes in certain real world situations. For example, if both an original check and a substitute check are presented to the paying bank, and if the original is returned as a duplicate because it hit the paying bank after the substitute check has cleared, the payee on the item may be debited for the return of an original. If the Check 21 warranties and indemnity do not travel “backward” to the payee who has only touched the original check, what legal claim would the payee have, and against whom? If the Check 21 warranties do apply, as the statute suggests, the payee would appear to have a cause of action against the reconverting bank. The Board may want to consider removing the clarification from the final version of the regulation, and leave in place the statutory scheme under which the reconverting bank makes the Check 21 warranties to every other party that receives in exchange for value the original, the substitute, or any representation of the substitute.

The statute and the proposed regulation set forth in multiple places the principle that a depositor should be made whole by the depositor’s bank (or possibly another bank in the web of warranties running back to the reconverting bank) when a substitute check (or its derivative) causes the depositor to suffer financial loss. Clearly, there is no policy reason why a bank should owe any recompense if a depositor has suffered no loss. However, neither the statute nor the proposed regulation makes it clear how a consumer’s bank can avoid compensating a consumer in the

following circumstances. Suppose a depositor submits a consumer recredit claim. The bank is unable to provide the original check or a better copy, but is able to recreate the chain of transfers on the basis of the “all items” files. The bank is able to establish that the payee received credit in the amount that the payee claims to have been owed, so the drawer’s obligation to the payee has been discharged. All that is still standing of the consumer’s claim for a recredit is the drawer’s assertion that somehow the payment of a substitute check has caused the drawer to suffer loss.

There does not appear to be a mechanism contemplated by the statute or the proposed regulation under which the bank can refuse to recredit the depositor or can revoke a recredit, once given, because it appears that the bank *must* provide the original or a sufficient copy to avoid liability. The Retail Payments Office believes the correct policy would be for a consumer to receive compensation only if the consumer substantiates that a financial loss occurred. Therefore, we believe the final regulation needs to make it clear that when a bank is able to substantiate no financial loss has occurred, the bank may deny or revoke a consumer recredit, even if the bank is unable to provide the original check or a sufficient copy.

Acknowledging the check processing world is highly complex, the RPO recommends the commentary address some of the operational details which may cause some difficulty in interpreting and applying Check 21. For example:

- What is the risk for a reconverting bank when a substitute check is stripped and encoded with no 4 in position 44 or other MICR fields are omitted by a prior bank before the item is image captured and reconverted into a subsequent substitute check? A common practice today with rejects is to strip and only encode the RT and amount. Does the stripping bank provide an encoding warranty? Could a person tell which bank stripped it?
- What is the risk for a qualified return substitute check that is returned with a 2 instead of a 5 in position 44? What is the warranty/liability of the returning bank? What is the risk for a subsequent reconverting bank of that document when the image will be shrunk to the point it may not be readable? The challenge in these two scenarios is that the reconverting bank will have no control of those items, yet it will provide the warranty and indemnity on them.
- What is the status of a substitute check that is created from an X9.37 file with an image of the original item that does not contain an encoded amount field? This should be clarified in the regulation with an example. The current discussion describes a missing amount as some type of error. In the electronic check world, the item would not require encoding for any purpose and would be missing the amount as a matter of practice, not as an error.
- What is the status of a substitute check of a qualified return with a Federal Reserve Bank encoded incorrectly as the bank of first deposit, a relatively common occurrence in today’s processing world where the Reserve Bank re-qualifies these with the correct routing number? This no longer is the “original” as submitted by the returning bank. How can we make a substitute check of it? Would it need to be returned to the paying bank as invalid for its correction?
- What is the status of a substitute check made from an item that had been stripped with only RT and amount because the original MICR information was

- unreadable? Is the substitute then the legal equivalent? Would it affect the warranty or indemnity of the reconverting bank?
- When original item rejects and is stripped by collecting bank the burden is on the collecting bank to full-field repair correctly with no control capabilities to ensure compliance as opposed to RTs (check digits) and amount (batch/bundle balancing.) It would appear the intent of the law could be circumvented if claims are easily made against the collecting bank for errors created during this process.

In addition, we would like to raise several issues with regard to endorsement standards. For example:

- When an original is imaged and reproduced on a substitute check, the area for the depositary is originally 3 inches from leading to 1.5 inches from trailing (width is 1.5 inches). For a personal check, the estimate is that the image on the substitute check is reduced to 80% of original (according to commentary in the regulation). If this happens, the 3 inch line from the leading edge moves to approximately 2.4 inches (3 inches times .8) from leading edge of substitute check. It appears that the electronic endorsement of the depositary bank placed on a substitute check (between 1.95 and 2.55 inches from the leading edge) could be overwritten and obscured by a bank endorsing as a collecting bank (current location defined as between the leading edge and 3 inches from the leading edge). While the Board addresses this issue by allocating the potential liability to a reconverting bank, it would seem desirable to work toward a solution that eliminates the technical problem. The Board might want to express a commitment to work with the standards community to solve this problem.
- The Board asks for comments regarding the ability to indorse on the front of checks being returned and what benefits might accrue. We envision several problems with this practice. One problem is that the area will be limited to the original image area if it is to survive future image conversions and subsequent substitute check creations. With the limited area and reduced original image that it would go into, it could make the image of the original item less readable and subject to warranty claims. Another potential issue relates to the overlaying endorsement on the front of a substitute check that might obscure any of the information on the front of the check at the time of truncation, thus violating one of the Check 21 warranties and one of the requirements for legal equivalence.

We encourage the Board to seek ways to clarify the final regulation as it relates to whether overlaying endorsements on the back of a substitute check in such a way that earlier endorsements become illegible would in itself mean that the substitute check fails the requirement for legal equivalence.

Finally, the Board has expressly asked for comment on the relatively narrow question of whether the proposed amendment to Regulation CC should include a provision that would adopt the most recent amendments to Articles 3 and 4 of the Uniform Commercial Code (UCC). These amendments partially reverse the venerable rule of *Price v. Neal* by making the bank of first

deposit rather than the paying bank liable if an item is paid over an unauthorized signature, but only if the item was remotely generated. The RPO believes that the latest revisions to the UCC reflect the correct policy and supports the idea of adopting the changes by including them in Regulation CC.

While not directly related to the public comment document, the RPO believes that the Board should consider carefully the future relationship between the Uniform Commercial Code and related federal laws and regulations. The implementation of Check 21 marks a significant turning point in the balance between state and federal law with respect to checks and is a very significant federal preemption of an area of law that has been left to the states and, more specifically, to the National Conference of Commissioners on Uniform State Laws (“NCCUSL”).

Specifically, Check 21 creates a new negotiable instrument unknown to the UCC and creates federal jurisdiction over all cases related to substitute checks. The proposed changes to Regulation CC include further preemptions of areas currently covered by UCC 3 and 4, an example of which is redefining terms that are central to check law, such as “transfer” and “consideration.” Finally, the proposal to use Regulation CC to adopt the latest changes in UCC 3 and 4 will preempt the state laws of the forty-odd states that have not yet adopted the latest version of UCC 3 and 4.

Moving forward, the RPO encourages the Board to consider the roles of the National Conference of Commissioners on Uniform State Laws, state legislatures, and the federal government, particularly the Board of Governors. Adopting the latest UCC changes by incorporating them in a federal regulation has appeal in that federal action, either in the form of statute or regulation, offers much greater speed in getting from conception to implementation. If the vision for the future relies more on federal initiatives to drive needed changes in payments law, we encourage the Board to carefully consider the resources, required to produce rules that are crafted as the National Conference of Commissioners on Uniform State Laws amendments to the UCC. The RPO recommends that the Board work with the National Conference of Commissioners on Uniform State Laws, the American Law Institute, and the legal staff of the Reserve Banks to build a model for legal innovation in payments law that capitalizes on the competencies of each of these parties.

Sincerely,



Patrick **IS.**Barron