

May 18, 2004

Ms. Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> and C Streets, N.W.  
Washington, DC 20551

Re: Additional Comments to Proposed Amendments To Regulation CC  
Docket No.: R-1176

Dear Ms. Johnson:

The undersigned financial services industry organizations and technology companies (the “Commenters”) participated at the May 3, 2004 meeting at the Federal Reserve Board to discuss certain issues relating to the Federal Reserve Board’s proposed regulation (the “Proposal”) to amend Regulation CC to implement the Check Clearing for the 21<sup>st</sup> Century Act (the “Check 21 Act”).

We want to thank the Federal Reserve for hosting the May 3<sup>rd</sup> meeting, and we appreciate the opportunity to set forth in this letter our views on certain of the topics discussed at the May 3<sup>rd</sup> meeting.

The attached document reflects the collective efforts of the undersigned Commenters.

If you have any questions regarding our comments, please contact any of the representatives of the undersigned Commenters.

Sincerely,

America's Community Bankers

Bank of America, N.A.

BITS

Electronic Check Clearing House  
Organization (ECCHO)

Electronic Payments Network L.L.C.

Independent Community Bankers  
of America

KeyBank

National Association of Federal  
Credit Unions

PNC Bank

The Clearing House

The Small Value Payments  
Company L.L.C.

American Bankers Association

Bank One

Credit Union National Association

Electronic Clearing Services L.L.C.

Huntington National Bank

JPMorgan Chase Bank

NACHA -- The Electronic Payments  
Association

National Clearing House Association  
(NCHA)

SunTrust Banks, Inc.

The National Check Exchange Company  
Company L.L.C.

Wachovia Corporation

## **ADDITIONAL COMMENTS TO PROPOSED REGULATION UNDER THE CHECK 21 ACT**

### **1. Legally Equivalent Substitute Checks with MICR Line Variations**

For the reasons set forth in our March 11 Comment Letter and at the May 3<sup>rd</sup> meeting, we support the removal of Section 229.51(c) of the Proposal, entitled “Purported Substitute Checks,” and the inclusion of a new provision that would expressly provide that a substitute check is the legal equivalent of the original check, even if an unrepaired MICR read or print error created by the reconverting bank causes the MICR line on the substitute check to vary from the MICR line on the original check.

We believe that the Federal Reserve has the authority under Section 15 of the Act to interpret the definition of “substitute check” in Section 3(16) of the Act to include as a “substitute check” an item with a MICR line variation from the MICR line of the original check. Section 15 of the Act gives the Federal Reserve authority to prescribe regulations as the Board determines “necessary to implement, prevent circumvention or evasion of, or to facilitate compliance with the provisions of the Act.” Providing legal equivalency to substitute checks is necessary both to implement the Act and to facilitate compliance with the Act. Providing legal equivalency for substitute checks with MICR line variations is necessary in light of the fact that the check processing system necessarily entails a certain amount of MICR line read and print errors (even without the substitute check process). Accordingly, to allow collecting and paying banks to process such MICR variant substitute checks and still provide legally equivalent checks to their customers, the Federal Reserve needs to provide legal equivalency to such items under the final regulation.

Moreover, to support the stated purpose of the Act to “facilitate check truncation by authorizing substitute checks,” we believe it is reasonable for the Federal Reserve to make appropriate modifications to the definition of substitute check to address MICR line variations. An overly narrow interpretation of the MICR line requirement in the definition of substitute check, for the reasons discussed at the May 3<sup>rd</sup> meeting and in our March 11 Comment Letter, will act as a disincentive to the acceptance of substitute checks by paying banks and their customers, and thereby decrease the potential for check truncation and greater efficiency in the nation’s check system.

Finally, the fact that Congress authorized the financial services industry to vary the MICR line on a legally equivalent substitute check compared to the original check by means of generally applicable industry standards in Section 3(16)(B) of the Act strongly supports a broader reading of the Federal Reserve’s legal authority with respect to the MICR line requirement. If an industry standards group can authorize banks to vary the MICR line of a substitute check, and still preserve the legal equivalency of such a check, it is reasonable to conclude that the Federal Reserve has authority to vary the MICR line requirement for substitute checks pursuant to its regulatory authority. If not, it would appear that the industry standards group had greater authority than the Federal Reserve to define classes of legally equivalent substitute checks. This odd result would seem to contradict the express authority of the Federal Reserve to regulate under the Act.

The Commenters recognize that providing legal equivalence to substitute checks with MICR read/print errors could cause a reconverting bank to be less concerned about delivering to a paying bank a substitute check with a MICR line that is not a complete reproduction of the MICR line of the original check. In such a case, the paying bank may have to incur additional processing costs to correct the MICR line on the check and post it. However, there is no evidence or expectation that there would be substantial non-compliance by reconverting banks with the MICR printing requirement. To the contrary, the reconverting bank has substantial incentive under the Act to print the correct MICR information on the check. Accordingly, we believe that there are less drastic, more directly-targeted, measures that the Federal Reserve and the financial services industry can undertake to decrease the likelihood that there will be non-compliance with the MICR line replication requirement.

First, to the extent that a reconverting bank is not complying with the MICR line replication requirement, it can be expected that bank clearing houses and correspondent banks will undertake measures, such as penalties or increased processing fees, that will deter a reconverting bank from continuing non-compliance. For example, a clearing house could establish a rule whereby if a reconverting bank is responsible for a certain number of non-conforming substitute checks exchanged through the clearing house to all other member banks during a monthly period, a fee would be imposed by the clearing house on the reconverting bank. Second, the Federal Reserve should, either in the Check 21 regulations or in the same day settlement rules, provide the paying bank with an optional right of return of a non-compliant substitute check, without presentment of that check being deemed to occur at the paying bank. To achieve this result, the Federal Reserve could define a substitute check with a variation in the MICR line as not complying with “other applicable law or rule” for purposes of Section 3-501(b)(3) of the UCC, thereby giving the paying bank the option to refuse payment or acceptance of the substitute check. Notwithstanding this new return right, the substitute check would still be the legal equivalent of the original check. This new return right for a legally equivalent substitute check would (i) give the paying bank flexibility to return the non-compliant MICR substitute check without risking a claim of wrongful dishonor by its customer, (ii) give the substitute check legal equivalency for all parties in the check collection process, and (iii) obviate the need for the paying bank to return the item as not being properly payable, which may result if the substitute check were not the legal equivalent of the original.

Finally, the Commenters would not support the regulatory approach, discussed briefly at the May 3<sup>rd</sup> meeting, that would allow a paying bank to act as a reconverting bank and recreate a “purported substitute check” into a legally equivalent substitute check. Besides creating unnecessary printing expense, we believe this approach would not address the legal equivalency issue for all banks in the check collection process. This re-creation approach would also be inconsistent with some current repair processes at paying banks that allow a paying bank to post a check with a MICR error to the customer account by electronically keying the MICR and not physically restripping the check with the corrected MICR.

## 2. Adoption of Industry Standards

As an alternative to interpreting the definition of “substitute check” to permit certain MICR line variations, the Federal Reserve may want to consider an approach that could address these MICR line variations and still preserve the legal equivalency of such substitute checks. The Federal Reserve could remove the Purported Substitute Check provision and indicate that MICR line variations may occur in a legally equivalent substitute check to the extent permitted in the generally applicable industry standards, as issued by the Accredited Standards Committee (ASC) X9, Inc.

The definition of “substitute check” in Section 3(16)(B) of the Act specifically authorizes the MICR line on a substitute check to vary from the original check as permitted by industry standards to facilitate the processing of substitute checks. Assuming there were no requirement in the final regulation regarding MICR line replication, the industry standards group could in its standard for substitute checks sets forth the specific extent to which a MICR line of a substitute check could vary from the MICR line of an original check, and still qualify as a “substitute check.” This approach would provide for legally equivalent substitute checks that contained MICR line variations, without requiring the Federal Reserve to interpret the definition of substitute check under its regulatory authority. This approach also would give the financial services industry flexibility to modify the MICR line variation standards as the industry gained more experience with the creation and processing of substitute checks.

## 3. Range of Permissible Variations of MICR Line

At the May 3<sup>rd</sup> meeting, the Federal Reserve staff raised the question of what should be the range of permissible MICR line variations that could occur on an item, and still have the item meet the definition of a “substitute check” under the Act thereby being a legal equivalent to the original check. While we have not determined the full range of permissible MICR line variations for a substitute check, at a minimum we recommend that the MICR line on the substitute check created by a reconverting bank be permitted to vary from the MICR line on the original check as the result of any of the following: (a) a misread or misprint of one or more MICR characters, (b) an omission of one or more MICR characters in the reading or printing process, and (c) a correctly read and printed character that is printed in MICR ink, but is not readable on an automated basis by the paying bank.

As a related matter, we support the position set forth in the white paper circulated at the May 3<sup>rd</sup> meeting that would allow the MICR line of the substitute check to vary from the MICR line of the original check as the result of repair by a bank in the check collection process or as a result of encoding position 44 to indicate the use of a substitute check.

#### 4. Other Variations From Definition of Substitute Check

In addition to the recommendations above regarding MICR line discrepancies, the Commenters acknowledge that there may be items created that otherwise deviate from the strict definition of “substitute check.” These deviations may cause the item to fail as a substitute check, and therefore not be the legal equivalent of the original check. However, because of automated processing, such items will be posted to customers’ accounts without paying banks knowing that such deviations exist. This issue was discussed briefly at the May 3<sup>rd</sup> meeting.

It is unclear at this time whether the volume of such non-conforming items will be so significant that additional protections for the paying bank (such as some form of a “purported substitute check” provision) need to be provided under the Check 21 regulations. In addition, we are concerned with how to define such non-conforming items without inappropriately expanding the scope of the Act and regulations. Accordingly, the Commenters propose that the Federal Reserve clarify in the final regulation that these non-conforming items (other than the MICR variations discussed above) are covered solely under the UCC, clearing house rules and customer agreements, and are outside of the coverage of the Check 21 Act and the Federal Reserve regulations implementing the Act. We also request that the Federal Reserve continue to study this issue, receive comments on this issue, and, if necessary, publish at the appropriate time a separate regulatory proposal for public comment on this issue.

#### 5. Certain Non-MICR Ink Substitute Checks

As a related matter to the Purported Substitute Check issue, the Commenters restate their support for the position set forth in the March 11 comment letter to allow a paying bank to print and deliver to its customers a substitute check that does not use MICR ink to print the MICR line. For the reasons stated above with respect to MICR line variations, we believe that the Federal Reserve should use its regulatory authority to implement the Act to expressly authorize these items in order to facilitate the processing of substitute checks. This will enable the paying bank to provide its customers a document that is the legal equivalent of the original check without causing the paying bank to incur the unnecessary expense of printing the substitute check using MICR ink which would serve no purpose.

#### 6. MICR Line From the Original Check at the Time of Truncation

The Commenters request that the Federal Reserve address in the final rule the issue of whether a substitute check should reflect the full MICR line from the original check (i) at the time the original check was issued, or (ii) at the time the original check was truncated into an electronic image.

We believe that if there has been a full field MICR repair of an original check, and the MICR line of the stripped original check varies from the original check at the

time of issuance, the reconverting bank should use the MICR line from the check at the time of truncation to create the substitute check. For example, a depository bank may undertake a full field repair on a deposited check to correct a routing number of a paying bank that has changed as the result of a merger. This full field repair would use an attached strip to repair the MICR line from the original check. Once repaired, the check with the strip would be imaged by the depository bank, and the image and the repaired MICR data sent forward to the collecting bank. If the collecting bank seeks to create a substitute check from that check image and data, the collecting bank would have access to the repaired MICR data read from the strip on the check and could not easily obtain the original MICR data from the check image.

#### 7. Replication of Non-Numeric Characters from MICR Line

The Federal Reserve staff indicated at the May 3<sup>rd</sup> meeting that it was considering providing guidance in the final rule that would address the appropriate treatment of certain non-numeric characters in the MICR line from the original check, particularly dashes and spaces, when creating a substitute check. We request that the Federal Reserve provide specific guidance on this issue in the final rule.

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