



Sent via e-mail: regs.comments@federalreserve.gov

July 26, 2004

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

Dear Ms. Johnson:

The Credit Union National Association (CUNA) appreciates the opportunity to provide comments for the Federal Reserve Board (Board) on its proposed revisions to Regulation J Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire. CUNA is a national trade association that represents approximately 90 percent of the nation's 9,400 state and federal credit unions, and this letter was prepared in conjunction with CUNA's Payment Systems Subcommittee, which is chaired by Lindsay Alexander, President and CEO of National Institutes of Health FCU, Rockville, Maryland

Summary Of CUNA's Position

- CUNA supports the amendment that would explicitly extend the coverage of Regulation J, so that it covers electronic items as well as paper checks.
- CUNA supports the amendments that would incorporate into Regulation J the substitute check warranties and indemnities and other existing indemnities and warranties that the Federal Reserve Banks and other banks will make under the Check Clearing for the 21st Century Act (Check 21) and Regulation CC when handling a substitute check or a paper or electronic representation of a substitute check.

- CUNA supports the inclusion of new warranties and indemnities, similar to those found in Check 21, which will apply when Reserve Banks and other banks send an electronic item that is not otherwise covered by Check 21.
- However, CUNA would like clarification in proposed Regulation J that the Reserve Banks will be liable on the same basis as any other financial institution for any flaws in the substitute checks that the Reserve Banks make when they receive acceptable images sent to them by other financial institutions.
- In addition, CUNA seeks clarification that the Reserve Banks will be subject to Check 21, like any other financial institution, and that they will honor the expedited recredit procedure mandated for financial institutions by Check 21.
- Finally, CUNA requests that the Federal Reserve clarify that the information associated with an electronic item must reflect the MICR line of the original check at the time of truncation, and not the MICR line when the original check was issued.

Discussion

The proposed amendments to Regulation J primarily are designed (1) to cover the Reserve Banks' handling of electronic items explicitly under Regulation J, (2) to acknowledge the substitute check and other existing warranties and indemnities the Reserve Banks and other banks will make under Check 21 and subpart D of Regulation CC when handling a substitute check or a paper or electronic representation of a substitute check, and (3) to include new warranties and indemnities that will apply when Reserve Banks and other banks send an electronic item that is not otherwise covered by Check 21 and subpart D of Regulation CC. CUNA supports all three of these amendments and discusses each of these in turn.

Electronic Items

CUNA supports the amendment that would explicitly extend the coverage of Regulation J, so that it covers electronic items as well as paper checks. Under existing Regulation J, the term "item" is understood to mean a paper instrument. Although Reserve Banks in some cases accept, transfer, present, or return items in electronic form, the rights and obligations associated with handling items electronically currently are specified in a Federal Reserve operating circular, rather than in Regulation J. This proposal would clarify within Regulation J that the rule also covers electronic items. This clarification that Regulation J applies to electronic items as well as paper items would help inform all stakeholders that the rule uniformly applies to all payment items.

Check 21 and Regulation CC Warranties and Indemnities

CUNA supports the amendments that would acknowledge the warranties and indemnities that the Federal Reserve Banks and other banks will make under Check 21 and Regulation CC. The Federal Reserve proposes that Regulation J explicitly acknowledge the warranties and indemnities that a sending bank makes under Regulation CC subject to the terms of that regulation. The proposal would list the settlement, encoding, and offset

warranties found in Regulation CC. In addition, the proposal would acknowledge explicitly that a sender makes the warranties and indemnity specified in subpart D of Regulation CC (which implements the Check Clearing for the 21st Century Act) when sending an item in the form of a substitute check or a paper or electronic representation of a substitute check. Although senders would make each of these warranties as provided in Regulation CC even if the warranties were not listed, the Federal Reserve believes that the meaning of the rule is clearer when these warranties are explicitly stated. CUNA agrees that explicit inclusion of these warranties clarifies the requirements for all items that are processed pursuant to this regulation.

New Warranties and Indemnities under Regulation J

CUNA supports the inclusion of new warranties and indemnities, similar to those found in Check 21, that will apply when Reserve Banks and other banks send an electronic item that is not otherwise covered by Check 21 and subpart D of Regulation CC. Specifically, the proposal includes new warranties and indemnities that will apply when Reserve Banks and other banks send an electronic item that is not otherwise covered by Check 21. For example, it would make each sender of an electronic item that is not a representation of a substitute check provide the Check 21 Act warranties to recipients of those electronic items, if those recipients later convert the item into a substitute check and incur a loss. Thus, these new warranties would allow the recipient of an electronic item to pass back liabilities incurred under Check 21 but for which the recipient did not receive Check 21 protections. A recipient could incur these liabilities if the recipient converted the item into a substitute check. In general, CUNA supports making the originator of the electronic item ultimately responsible for the warranties and indemnities associated with that item, if they are the source of the problem.

However, CUNA would like clarification in proposed Regulation J that Reserve Banks will be liable on the same basis as any other financial institution for any flaws in the substitute checks that the Reserve Banks make when they receive acceptable images sent to them by other financial institutions. CUNA believes that if the sender of the electronic item transfers an acceptable image, but the Reserve Bank errs in creating the substitute check from that image, then the Reserve Bank should be held liable for the error. The limitation on liability in proposed Section 210.6(c) could be interpreted to exclude Reserve Banks from liability for creation of substitute checks under Check 21. Therefore, we urge the Board to clarify in this section that Reserve Banks are also subject to the Check 21 warranties, indemnities and other responsibilities associated with the creation of a substitute check.

In particular, to alleviate confusion CUNA supports a provision that a Reserve Bank is subject to the expedited recredit procedures for substitute checks. As presently drafted, the proposed section 210.6 (c) could be interpreted to specifically exclude Reserve Banks from the expedited recredit procedure. We encourage the Board to clarify that nothing in the regulation exempts a Reserve bank from the expedited recredit procedure for banks that is required under Check 21.

Finally, CUNA requests that the Federal Reserve clarify that the information associated with an electronic item must reflect the MICR line of the original check at the time of truncation, and not the MICR line when the original check was issued. If this language is added to Regulation J, then it will clarify that the financial institution creating the electronic item is not required to “de-strip” the check (i.e., remove the strip containing a repaired MICR line) to determine the check’s MICR at the time of issuance. CUNA supports this change because it would allow a financial institution to rely on the most current MICR line of the check when creating an electronic item.

Conclusion

CUNA generally supports the attempts by the Federal Reserve to update Regulation J to accommodate electronic items and the Check 21 Act. If you have any further questions, please contact CUNA's Senior Vice President and Associate General Counsel Mary Dunn or me at (202) 638-5777.

Sincerely,

Michelle Profit

Michelle Q. Profit
Assistant General Counsel