

**MICR-LINE ISSUES ASSOCIATED WITH
THE CHECK 21 ACT AND THE BOARD'S PROPOSED RULE**

**Prepared by Federal Reserve Board Staff
April 27, 2004**

1. Overview of statutory MICR line requirement and the proposed rule.

A. Statutory MICR-line requirement for substitute checks – § 3(16)(B).

1. Requires a substitute check to “bear a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks.” This requirement is separate from the requirement that the substitute check contain an image of the original check.

B. Proposed rule.

- **12 CFR 229.2(zz)(2) (substitute check definition) and Commentary**
 2. Paragraph 5(a) of the commentary says that the industry standard (ANS X9.90) requires a 4 or 5 in position 44.
 3. Paragraph 5(b) of the commentary would permit but not require an additional variation to allow banks to correct an amount-encoding error that appeared on an original check (to promote processing of substitute checks in the same manner as original checks, because banks routinely correct errors on originals).
 4. Paragraph 5(c) of the commentary clarifies that no other MICR-line variations are permissible. Most likely source of a MICR error not present on the original check would be if check-processing/imaging equipment did not accurately read the original MICR line. Proposed rule therefore highlighted MICR-read errors as an impermissible MICR-line variation.
- **12 CFR 229.51(c) (purported substitute check provision) and commentary**
 5. Acknowledged that a check with a MICR error may still be processable even though it does not meet the substitute check definition. Proposed rule would subject such a “purported substitute check” to the substitute check warranties, indemnity, recredit, and consumer awareness provisions to give certainty and Check 21 protections to subsequent recipients.

II. Overview of MICR-related comments and issues.

A. Variations and repairs.

1. Original check's MICR line varies over time as it is amount-encoded and/or stripped. At what point is the MICR line on the original check the measure for what must be in the MICR line of the substitute check?
2. What is the status of a substitute check made from an original check that was stripped with only the bank routing number and amount prior to truncation? Would a substitute check that only reproduced the MICR strip be a legal equivalent?
3. What is the status of a substitute check created from an X9.37 file (or an original check) that does not have an encoded amount field? Unencoded amount should not be considered an error, as suggested by proposed rule.
4. Why permit a bank to correct an amount-encoding error on an original but not permit it to correct an error in other field of the MICR line of an original?
5. Disagree with Board's treatment of MICR-line repair issues generally. Suggest alternative approach: a substitute check should have a full MICR line (in magnetic ink) and failure to meet that requirement violates Check 21, but an item with a MICR error nonetheless should be a legal equivalent. Problems with substitute check MICR line should be covered under UCC encoding warranty.
6. Proposed rule inadequately addresses the issue of MICR repair by banks other than the reconvert bank. Rule should encourage MICR repair of substitute checks in the same manner as original checks are repaired. Bad repair should be a breach of the UCC encoding warranty but should not implicate the Check 21 warranties.
7. What is the status of a substitute check sent as a qualified return that incorrectly identifies the depository bank? May a collecting bank correct the encoding error, or must it return the item to the paying/returning bank for correction?

B. Use of magnetic ink.

1. For limited purpose of returning paid checks to depositors, reconvert bank should be able to create a substitute check without using magnetic ink.
2. Would something without magnetic ink be a purported substitute check?

C. Specific issues concerning position 44.

1. Is proper encoding of position 44 required to create a valid substitute check?
2. Substitute check with misencoded/unencoded position 44 should be legally equivalent; remedy should be the UCC encoding warranty.

3. Clarify that a “4” will be placed in position 44 of the actual substitute check MICR line but a “5” will be applied by adding a strip to a qualified return.
4. Clarify liability for failure to encode position 44 correctly; reconvert bank that failed to encode should bear losses for later substitute checks that aren’t legally equivalent because of shrunken image.
5. What’s the potential liability for a returning bank that creates a qualified returned substitute check with a 2 instead of a 5 in position 44, particularly if that item is then used to create a second substitute check?
6. If a collecting bank receives a substitute check stripped without a 4 in position 44, then image-captured that substitute check and converted it to a second substitute check, does the bank that stripped the check provide an encoding warranty?

D. Purported substitute checks.

1. Purported substitute check provision should apply to a substitute check that fails any of the underlying substitute check requirements, not just the MICR-line requirement.
2. Board should clarify when a document would purport to be a substitute check.
3. Board should delete purported substitute check provision because it creates uncertainty; not clear whether a subsequent bank has authority to repair something that’s not a legal equivalent.

111. Board staff’s goals for MICR-line replication and repair.

A. Clearly establish the MICR line requirements to be a substitute check.

Establish the appropriate time at which the original check’s MICR line becomes the measure for the sufficiency of the substitute check’s MICR line and clearly identify what, if any, variations from that MICR-line are permitted or required. A basic principle of Check 21 is that banks receiving substitute checks need not change the way in which they process checks. Banks therefore should be able to access and rely on the MICR line of a substitute check in the same way that they currently rely on the MICR line of an original check.

B. Clarify the legal status of a document that contains a MICR line that does not meet the statutory/regulatory requirements to be a substitute check. This should address the status of such a document under both the Check 21 Act/subpart D and the UCC.

1. A document that doesn’t replicate the MICR line of the original check within the parameters established by the rule is not a substitute check and therefore is not the

legal equivalent of an original check and does not carry Check 21 Act protections. A bank that creates such a document thus could avoid Check 21 liability, and recipients would be without Check 21 protections. These incentives should be discouraged.

2. Clarify whether a document without a compliant MICR line (or that fails any other substitute check requirement) is an “item” that can be repaired and collected under the UCC; clarify the application of the UCC and Reg. CC encoding warranties to the initial substitute check MICR line, position 44, and subsequent repairs.

C. Clarify the rules that apply to MICR repair.

Basic theory should be to facilitate processing of substitute checks as if they were original checks, within the bounds of the basic statutory requirements for substitute checks.

IV. Alternative MICR-line framework that better achieves stated goals.

A. Basic MICR-line replication requirement – substitute check must bear original check’s when-issued MICR line.

A reconverting bank when creating a substitute check must replicate the MICR line information that appeared on the original check at the time that the original check was issued (i.e., the MICR information that is preprinted on the check).

B. Proper encoding of position 44 – required because of industry standard prong, not MICR-line replication prong, of substitute check definition.

In addition to replicating the original check’s when-issued MICR line, a reconverting bank must properly encode position 44. This requirement comes not from the MICR-line replication criterion of the substitute check definition, but rather from the “must conform to industry standards for substitute checks” criterion (ANS X9.90, the relevant industry standard, requires proper encoding of position 44). Commentary could clarify how a reconverting bank could comply with the position 44 encoding requirement (e.g., add the 4 to a forward-side substitute check directly if position 44 was blank on the original check (or by strip if position 44 of the original was encoded for forward collection); add the 5 to a return-side substitute check by strip).

C. Reconverting bank and other banks may strip a valid substitute check as needed, subject to encoding warranties.

A substitute check that at the time of its creation contained the when-issued MICR line of the original check and met the other substitute check requirements would be a substitute check and could be stripped as necessary for forward

collection and/or return (just as an original check could) without altering the item's status as a substitute check. Misencoded strips (other than position 44 as encoded by the reconverting bank) would not implicate legal equivalence, warranties, or indemnities under Check 21 but would be covered by the UCC and Reg. CC encoding warranties, just as they are today.

D. Amount-encoding a substitute check – permitted but not required, just as for original checks today.

The reconverting bank or a subsequent bank could encode the amount on the substitute check. This would be considered an addition to the required MICR-line information, not a variation from it. Just as with original checks, a substitute check's legal status would not be affected by amount encoding, and amount encoding would not implicate legal equivalence or warranties under Check 21. Amount-encoding errors on substitute checks would be covered by the UCC and Reg. CC encoding warranties, just as they are today for original checks.

E. Purported substitute checks.

Purported substitute checks generally. A document that does not meet the substitute check definition because of a MICR-line deficiency still may be sent through the check collection process as if it were a substitute check. Recipients therefore should have the full range of Check 21 Act protections. Such an item thus should be subject to all parts of subpart D except for § 229.51(a) (legal equivalence) and 229.51(d) (application of other law to legal equivalents). Therefore, a failure to replicate the MICR line or to encode position 44 correctly could give rise to a Check 21 warranty claim (breach of the legal equivalence warranty) or to an indemnity claim (check would have been processed correctly and/or image wouldn't have been subject to shrinkage if original had been transferred instead).

Note: Purported substitute check provision of proposed rule states that an item is purported substitute check if it meets all the substitute check criteria except the MICR-line replication requirement. Therefore, something that does not use magnetic ink is not a purported substitute check under the proposed rule, because that document also fails the "suitable for automated processing" and "industry standard" criteria.

Query: Should failure to meet any of the other substitute check criteria also give rise to purported substitute check liabilities?

Query: Should a purported substitute check be able to become an actual substitute check eligible for legal equivalence if a bank corrects the MICR-line error such that it matches the original check's when-issued MICR line?

2. Legal status of purported substitute checks. A collecting, paying, or returning bank would not be required to repair, transfer, or charge a customer's account for a purported substitute check and could return the purported substitute check on the grounds that it is neither the legal equivalent of an original check nor an item under the UCC. However, if the basic payment information (bank routing number, account number, and amount) on the purported substitute check were correct, a bank might not detect that it was handling a non-legally-equivalent substitute check, and the paying bank might charge the customer's account. This would be similar to the treatment of copies in lieu (which are not checks or legal equivalents of checks) today. A bank that transferred or paid a purported substitute check would potentially be liable for the Check 21 Act warranties and indemnity, but that would only arise in practice if there were a problem with the purported substitute check. In other words, a bank would not be prevented from repairing or charging for a purported substitute check, but it would take on a warranty/indemnity risk in doing so.

**MICR-LINE ISSUES ASSOCIATED WITH
THE CHECK 21 ACT AND THE BOARD'S PROPOSED RULE
Final Agenda for May 3,2004**

- I. Brief overview of:
 - i. Statutory MICR line requirements
 - ii. The Board's proposed rule
 - iii. Issues raised by commenters

- II. Discussion of goals for MICR-line replication/repair and alternatives for achieving them:
 - i. Clarify what a MICR line must contain to meet the substitute check definition
 - ii. Clarify the effect of check stripping, before or after creation of a substitute check
 - iii. Clarify the rules for adding to or repairing a MICR line
 - 1. Position 44
 - 2. Amount
 - 3. Other fields
 - iv. Handling of items that purport to be substitute checks but do not meet the substitute check definition because of a MICR-line error
 - 1. Which parts of subpart D should apply to items with a MICR-line error?
 - 2. Can/should banks be able to repair a MICR-line error and thereby create a compliant substitute check?
 - 3. Should a document that does not meet the substitute check definition for a reason other than a MICR-line error be treated as a purported substitute check?

MICR-line issues associated with the Board's proposed rule to implement the Check 21 Act
Notes of 05/03/04 meeting with commenters

See attached attendee list. Participation in the meeting was limited to organizations that specifically raised MICR-line issues in their comment letter.

MICR line requirements

Review of Check 21 statute and Board's proposed rule

Board staff opened the meeting by restating the MICR-line requirement in section 3(16)(B) of the Check 21 Act:

Substitute check. The term "substitute check" means a paper reproduction of the original check that— * * *

- (B) Bears a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks; * * *

Board staff outlined the scope of permissible MICR-line variations set forth in its proposed rule (issued December 22, 2003) implementing this statutory provision:

- (1) Industry standards require position 44 of the MICR line of the substitute check to vary from position 44 of the MICR line of the original.
- (2) The amount field of the MICR line of the substitute check may vary from the amount field of the MICR line of the original.
- (3) No other variations would be permitted. That is to say, any other variation would cause the item in question to fail to meet the statutory definition of a substitute check, such that the item could not be the legal equivalent of an original check.

Alternative treatment of MICR line

Board staff then set forth a possible alternative regulatory treatment of MICR-line replication and repair:

- (1) A substitute check must bear the preprinted MICR line information from the original check (the original check's "when-issued" MICR line).
- (2) Proper encoding of position 44 of the substitute check is required by section 3(16)(C) of the statute, which requires a substitute check to conform with generally applicable industry standards for substitute checks.

- (3) A substitute check that at the time of its creation contained the when-issued MICR line of the original check (and met the other requirements of the substitute check definition) would be a substitute check and could be stripped as necessary for collection and/or return without altering the item's status as a substitute check.

Handling of items with MICR-encoded strips

Industry commenters expressed concern about the potential impact on paying banks of receiving substitute checks with a MICR line containing only the paying bank's routing number and amount. Board staff asked how paying banks currently deal with original checks that have been "stripped" with the paying bank's routing number and amount. Commenters responded that paying banks do one of three things:

- (1) The paying bank de-strips the item to read the original check MICR line;
- (2) The paying bank "reads high," i.e., the paying bank's check processing equipment reads the original MICR line that is now above the stripped MICR information; or
- (3) The paying bank's clerk, visually inspecting the item, manually key-enters the original check's MICR line information.

Board staff noted that paying banks would be able to do neither (1) nor (2) with respect to a substitute check with a MICR line that did not contain all of the fields from the original check's MICR line. Board staff also noted that, in order for a bank's depositor to be able to redeposit a substitute check that had been returned unpaid, the substitute check would need to bear a MICR line sufficient to permit the check to be processed for forward collection. Commenters generally agreed.

Position 44 of MICR line

Position 44 normally is left blank on forward-collection checks, but banks occasionally encode it (usually with an '8' or '9'). The question arose as to what would happen to a character contained in position 44 of an original check's MICR line if the original check subsequently were to become a substitute check, which is required by industry standards to have a '4' in position 44. Would a reconverting bank be allowed to vary the content of position 44 to meet the substitute check requirement, or would it need to replicate the original check's encoding of that

position? A commenter stated that the '4' needed for the substitute check would be mandatory, such that the character contained in position 44 of the original check's MICR line would be lost. This commenter noted that the ability to change the content of position 44 in the MICR line of a substitute check was the reason for the exception clause in the MICR-line prong of the Check 21 Act's substitute check definition. Several other commenters supported this position.

Reconverting bank responsibility for MICR line

Several commenters noted that (1) under the statute, banks are not required to create substitute checks, though banks may choose to do so where it is to their benefit, (2) substitute checks with incomplete or incorrect MICR lines would create increased burden for banks that receive substitute checks, and (3) an overarching principle for the Board's final rule should be to put banks and consumers that receive substitute checks in the same position that they would be in had they received the original check, to the extent practicable. Commenters agreed that it is important for the Board to fashion a rule that places the responsibility on the reconverting bank (the bank that creates a substitute check) to ensure that a substitute check contains a full and accurate MICR line.

Given the statutory requirement that a substitute check bear a MICR line containing "all the information" from the original check's MICR line, Board staff asked commenters whether they would have any concerns with a final rule that made the when-issued original check MICR line the measure of what the substitute check MICR line should replicate. Commenters responded that this measure could be problematic with respect to original checks that had been stripped prior to truncation. Commenters noted that their check processing equipment could detect checks with strips containing only the paying bank's routing number and the check dollar amount. However, they further noted that, if the strip were full-field encoded, their equipment would likely not be able to detect that the item had been stripped, and they in turn would not be able to determine whether the MICR information on the strip differed from the original check's when-issued MICR line. Commenters also stated that the when-issued MICR line could potentially contain an error, the primary example being that the routing number on an original check may be "obsolete" and that collecting banks sometimes strip the check with the updated routing number. Commenters generally agreed that, with the exception of the routing number

field, collecting banks have no way of determining if there is an error in a field of the original check's when-issued MICR line. It was noted that X9.37 – the industry standard for exchange of electronic check records – contains data fields for only one forward-collection MICR line.

Commenters stated that the extent of the burden placed on reconverting banks by a final rule that makes the when-issued original check MICR line the measure of what the substitute check MICR line should replicate would be difficult to calculate or predict without knowing the legal ramifications of creating a “substitute check” with a MICR line that did not match that of the original check.

Purported substitute checks

Purported substitute check provision of Board's proposed rule

Board staff noted that there could be cases in which a substitute item does not bear a MICR line containing “all the information” from the original check's MICR line, *i.e.*, does not meet the statutory definition of “substitute check,” and therefore is not be subject to the Check 21 Act. Staff asked how the Board's final rule should protect recipients of these items, noting that the Board's proposed rule provided the Check 21 Act's warranty, indemnity, and expedited recredit protections to recipients of these items.

Commenters generally agreed that the Board's final rule should protect recipients of purported substitute checks, but that it was important that the Board fashion a rule such that banks would be able to charge purported substitute checks with correct payment and routing information to their customers' accounts, as opposed to rejecting or returning them. Practically speaking, commenters said, it is imperative that such purported substitute checks “clear without issue 99.9 percent of the time” because that is what banks' customers will expect.

Legal status of purported substitute checks under the Uniform Commercial Code

Commenters voiced concern that paying banks would not want to charge a customer's account for a purported substitute check if it would not be legally equivalent to the original check under the Act or regulation because its status under the Uniform Commercial Code would be

uncertain. Board staff raised the question of whether purported substitute checks would qualify as “items” under Article 4 of the UCC and whether it would be permissible for banks to transfer the items and/or charge them to customers’ accounts. Staff noted that banks currently transfer and/or charge some non-legally-equivalent items, such as photocopies-in-lieu. Commenters stated that they believed transferring and charging purported substitute checks would require agreement of the parties involved and that account agreements and clearinghouse rules commonly address photocopies.

Possible legal equivalence for purported substitute checks

Commenters asked why one would not want to make purported substitute checks nonetheless be the legal equivalent of the original check (provided that the image of the original check is accurate). Such a rule would permit banks to charge the purported substitute checks to customer accounts and would alleviate concerns with respect to making the when-issued original check MICR line the measure of what a substitute check should match. Board staff responded that the primary issue was whether anything other than a substitute check could be a legal equivalent in light of section 4(b) of the Check 21 Act (emphasis added):

A substitute check shall be the legal equivalent of the original check...if the substitute check (1) accurately represents all of the information on the front and back of the original check as of the time the original check was truncated; and (2) bears the legend: “This is a legal copy of your check. You can use it the same way you would use the original check.”.

Board staff also asked commenters where they would draw the line on what types of items that do not fully meet the Act’s definition of substitute check should qualify as the legal equivalent of the original check. Some commenters suggested using standards such as “best efforts” or “except as explicitly excluded under UCC presentment agreements.” Others were less comfortable with the breadth of these suggestions, and some maintained that the Board’s final rule should include penalties for missing data. Commenters noted that Board staff should balance bank and consumer perspectives.

Board staff asked commenters if they had ideas for an alternate approach that would ensure that reconverting banks create substitute checks that conform to the Act’s requirements

and that can properly be charged to customer accounts. Commenters did not specifically answer, but stated that they believe that the Board's proposed purported substitute check provision represents a "sledgehammer approach." Commenters also noted their belief that the Check 21 Act (section 15) provides the Board with sufficiently broad implementing authority to interpret the Act's substitute check definition. In this regard, commenters focused on the clause "except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks" contained in section 3(16)(B) of the statute. Board staff noted that section 6.1.5 of ANS X9.90 – the applicable industry standard for substitute checks – provides that

If this IRD is being used under the Check Truncation Act [now Check 21], the MICR line data shall reflect all the information encoded on the original check at the time the original check was issued as well as the amount.

Commenters expressed their desire that Board staff work to fashion a legal theory that would permit a purported substitute check to be the legal equivalent of an original check. Commenters noted that, should the Board's final rule deem a substitute item with a MICR line varying from that of the original check to be a legal equivalent, the Board could use the Check 21 Act's general liability provisions (section 10 of the Act) to nonetheless place liability on the reconverting bank for any damages resulting from the substitute item's non-compliant MICR line.

Use of magnetic ink

Board staff noted that several commenters had suggested that the Board's final rule permit reconverting banks to create a substitute check with a MICR line in nonmagnetic ink when the reconverting bank is creating the substitute check solely for the purpose of returning the paid check to the drawer with a monthly account statement. Commenters had noted that drawers do not require that paid checks be suitable for automated processing and that providing paid checks with MICR lines in nonmagnetic ink would be more cost effective. Board staff asked commenters if corporate drawers might need paid checks' MICR lines to be in magnetic ink to facilitate their own internal payment processes. Commenters responded that if a given

corporate customer requires magnetic ink, then the banks would be able to provide that. Commenters also noted that corporate drawers' internal processes generally do not rely on magnetic ink, but are instead based around electronic files of MICR information.

Meeting Attendee List

Organization	Representative	Attendance
1st Source Bank	Peggy Voorheis	Tel
American Bankers Association	Nessa Feddis	In person
America's Community Bankers	Rob Drozdowski	In person
Association of Corporate Credit Unions	Mike Canning	In person
Association of Financial Professionals	Arlene Chapman	Tel
Bank of America	Jeanette Blanco	In person
Bank of Floyd	Betty Whitlock	Tel
Bank One Corporation	Molly Carpenter	In person
Banknorth, NA	Michael Crowley	Tel
BITS	Gary Roboff	Tel
Citibank	Christian Riehl	Tel
City National Bank	Neil Martin	Tel
Commerce Cash Management	Roy Spooner	In person
Commercial Federal Bank	Jim McGrail	Tel
Consumers Union	Gail Hillebrand	In person
Credit Union National Association	Michelle Profit	In person
Deutsche Bank	Jim Guerra	Tel
Electronic Check Clearing House Organization	David Walker	In person
Federal Reserve Bank of Atlanta	Pat Barron	Tel
Federal Reserve Bank of Minneapolis	Jim Lyon	In person
Federal Reserve Retail Payments Office	Fred Herr	In person
First Tennessee Bank	Janet Honeycutt	Tel
FirstData Corporation	Adam Coyle	Tel
Fiserv	Bill Saffici	Tel
Georgia CU League	Cindy Connelly	Tel
HSBC	Gea Tung	Tel
Huntington Bank	Jim Posani	Tel
Independent Community Bankers Association	Viveca Ware	In person
JPMorgan Chase Bank	Lloyd Harris	In person
KeyBank	Brian Guess	Tel
Massachusetts Bankers Association	Tanya Duncan	Tel
MidAtlantic Corporate Federal Credit Union	Jeffrey Stoner	In person
MidStates Corporate Federal Credit Union	Terry Faurote	Tel
NACHA	Ian Macoy	In person
National Association of Federal Credit Unions	Kimberly Dewey	In person
Navy FCU	Gary Simpson	Tel
NCR Corporation	Tim Day	Tel
New York Bankers Association	Roberta Kotkin	Tel

Organization	Representative	Attendance
Permanent Editorial Board for the UCC	Sara Jane Hughes	In person
PNC Bank	Kathleen Kerrigan	In person
Schwartz & Ballen	Tom Fox	In person
Southeast Corporate Credit Union	Kay Moon	Tel
SunCorp Corporate Credit Union	Cynthia Koan	In person
SunTrust Banks, Inc.	Jose Lopez-Isa	In person
The Clearing House	Henry Wysocki	In person
The Savings Bank	Sally Kaldas	Tel
Tyler Cooper & Alcom, LLP	Fillis Stober	In person
US Bank	John King	Tel
WACHA	Mary Schnell	Tel
Wachovia Corporation	Camilla McDevitt	In person
Wells Fargo & Company	Ted Kitada	In person
Western Corporate Federal Credit Union	Sheri Ledbetter	Tel
World Savings Bank	Peter Cowger	Tel

Note: The Board did not take a roll call of meeting participants. Telephone attendees listed above represent those who notified the Board beforehand that they planned to participate.