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"Gary Nesbitt" <gnesbitt@eastpay.org> on 10/20/2003 03:38:05 PM

To: <210comments@fms.treas.gov>
cc:
Subject: EastPay's comments on 31 CFR 210

Attn: Mr. Stephen M. Vajs
Director, Risk Management Division
Financial Management Service
US Department of Treasury

Mr. Vajs
Attached are EastPay's comments on the proposed changes to 31 CFR 210. These comments are in the form of a Word document. Please let us know if there are any problems with receiving and opening this document.

On behalf of our over 650 financial institution members, EastPay appreciates the opportunity to provide input into the Treasury's proposed Rule making process. Please feel free to contact me with any questions or should any of our comments need clarification.

Gary B. Nesbitt, AAP
EastPay
(800) 545-5922

Mark your calendar for Information Interchange, Feb 8-10 2004 in Orlando.
www.eastpay.org

- 31cfr210 comments-EastPay.doc

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VIA E-MAIL
October 20, 2003

Stephen M. Vajs
Director, Risk Management Division
Financial Management Service
U.S. Department of the Treasury
Room 423
401 14th Street, SW
Washington, DC 20227

Re: 31 CFR Part 210 -- Government Participation in the Automated Clearing House ("ACH") Network

Dear Mr. Vajs:

On behalf of EastPay,[1] I respectfully submit these comments in response to the notice of proposed rulemaking ("NPRM") issued by the Treasury Department's Financial Management Service ("FMS") regarding proposed changes for Federal agency payments from what is currently supported by the NACHA Operating Rules ("NACHA Rules") governing electronic check conversion. Attached are EastPay's detailed comments with respect to the relevant proposed changes in the NPRM.

EastPay and NACHA have a long history of promoting electronic payment methods. EastPay recognizes that FMS' intent with this NPRM is to further promote electronic collection alternatives. However, we are deeply concerned about significant divergence from the NACHA Rules. This divergence began with the changes to 31 CFR Part 210 adopted in April 2002 allowing conversion of business checks for Federal agency payments. The proposed changes in this NPRM represent further substantial diversion from what is permitted by the NACHA Rules.

The U.S. Government is the single largest ACH Originator, and as such its rules apply to a significant portion of total ACH volume. The consistency between 31 CFR Part 210 and the NACHA Rules that has been in place for several years has served both the Federal government and the private sector well through cost savings and reduced regulatory burden due to the common approach to ACH processing for both government and commercial ACH transactions. Therefore, we strongly oppose several of FMS' proposed changes to electronic check conversion policies. We support and endorse the comments that NACHA has provided on this proposal.

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[1] **About EastPay:** EastPay is one of the twenty regional ACH and payments associations that are members of NACHA. EastPay represents more than 650 financial institutions in a number of states in the southeast. We provide training and education, as well as technical, operational and marketing support for our members. EastPay is an active member of NACHA's Electronic Check Council, as well as the Internet Council, and Council for Electronic Billing and Payment. Visit EastPay on the Internet at: www.eastpay.org.

Specifically, the inconsistencies with the NACHA Rules inherent to FMS' proposed changes would:

- Substantially increase costs to the private sector and the regulatory burden associated with processing Federal agency payments;
- Create confusion among consumers and businesses as Federal agency customers or beneficiaries; and,
- Undermine financial institution and other financial services provider services and customer agreements.
- Possibly exacerbate the ACH rules compliance issues with current echeck originators and lead to consumer confusion and distrust of the ACH network.

Increased Costs and Regulatory Burden: Divergence from the NACHA Rules for Federal agency electronic check conversion payments will require financial institutions and other issuers of checks that would be converted to bear costs associated with greater volume of exception items, legal disputes over appropriate authorization, systems changes to recognize and outsort Federal agency conversion entries for special handling, and customer service inquiries, complaints and dispute resolution.

Moreover, contrary to FMS' assessment in the NPRM, EastPay believes FMS' proposed changes do represent a "significant regulatory action," given the likely impact on consumers, businesses and financial institutions. For example, financial institutions will have to expend millions of dollars industry-wide to employ systems that could identify Federal agency-initiated ACH entries drawn on business accounts so that a prompt and proper review for authorization could be conducted. Further, financial institutions, businesses and government agencies that issue checks to third-parties that could be used as payment to Federal agencies (e.g., official checks, cashier's checks, credit card convenience checks, money market mutual fund checks, money orders, state warrants, etc.) would have to employ complex verification systems to ensure that such checks were legally authorized for conversion by the check issuer and were properly payable (i.e., not forged, counterfeit, or altered). We also do not believe that FMS has adequately thought through the costs, both to the Federal government and to the private sector, associated with potentially significant volumes of returned ACH entries having to be processed and replaced with demand drafts, which may also be returned for lack of appropriate authorization. Finally, it is likely under the scenario envisioned by FMS that individuals and businesses will frequently incur late payment fees or penalties, simply because the check conversion entry had to be returned (and, possibly, the resultant demand draft also returned) in today's operational and legal environment.

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EastPay expects the sum total of these costs will be significant to financial institutions, to businesses and to consumers, and this is not reflected in the NPRM through a proper economic impact analysis. Nor does EastPay share FMS' optimism when it comes to federalism issues, as there may also be a direct impact on the States whose laws generally govern check negotiability and collection. States will also be impacted as senders and receivers of Federal agency payments, as issuers of state warrants, and as lawful regulators of various forms of check use, such as money orders issued by money services businesses.

Marketplace Confusion: Check conversion (e.g., through the ACH Network) and check truncation (e.g., as supported by the *Check Clearing for the 21st Century Act*, or "Check21") are relatively new and still evolving payment applications. While both approaches to the reduction in physical check collection are very promising, consumers and businesses have not yet necessarily adapted to these processes, or fully recognize their associated legal rights and responsibilities when a check is converted or truncated. FMS adopting divergent approaches to the types of checks eligible for conversion to ACH entries, the authorization procedures associated with each application and its reliance on the Receiver's financial institution to sort it out is a recipe for confusion, disputes, and payment uncertainty.

EastPay (as well as FMS and other agencies for that matter) have worked long and hard to build a consistent approach with clear benefits to consumers, businesses and financial institutions. The changes proposed in the NPRM, if adopted, would only cloud the matter and lead payments system users to question the benefits associated with conversion. Further, check collection processes that would be supported under Check21, when implemented next year, offer many of the same benefits that FMS is seeking through this NPRM, and all types of checks are eligible for truncation under the Act. EastPay would encourage FMS to refrain from adopting the check conversion proposals in this NPRM and look instead to harnessing the benefits of truncation under Check21 to the Federal government's advantage.

Many business entities that use the represented check application are eager to eliminate the consumer specific authorizations that are currently in the ACH Rules and provide greater consumer protection than Regulation E does for these single items. We are concerned that many of these entities may use the Treasury's "rules" as their basis for not following the NACHA Rules. We have some significantly ACH Rules compliance issues today with these types of situations and think that the proposed Treasury rules would only exacerbate this non-compliance issue for financial institutions and the ACH network.

Position of Financial Institutions: Adoption of the proposed check conversion changes to 31 CFR Part 210 would compromise many of the services financial institutions and other businesses provide to their customers. In some respects, it could also place an institution or business in an adversarial relationship with its customer, solely due to the Federal government's different policies governing ACH payments. For example, converting a check that was issued by a financial institution or business to a third party could directly conflict with account agreements (i.e., between the financial institution the check is drawn on and the issuer of the check), various state laws governing check negotiability, and the operational capabilities supporting corporate treasury services. At a minimum, the issuing party and the financial institution will be called upon to explain why payment was either not made, or conversely, why payment was made without the issuer's authorization.

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EastPay, on behalf of its member institutions, is committed to working closely with FMS and other federal agencies to expand the opportunities offered by electronic check conversion of checks for Federal agency payments. We would be interested in working with the appropriate FMS staff to explore how FMS can continue to reduce hurdles to electronic conversion without having to rely on significant divergence from the NACHA Rules so that a consistent and coordinated approach can be taken. If you have any questions regarding EastPay's comments, please do not hesitate to contact me by e-mail at: gnesbitt@eastpay.org, or by telephone at (704) 366-7292.

Sincerely,

Gary B. Nesbitt, AAP
Senior Vice President

Attachment: EastPay Comments on 31 CFR Part 210 Proposed Changes

EastPay COMMENTS ON 31 CFR PART 210
October 20, 2003

A. Check Conversion

The 2002 changes to 31 CFR Part 210 allow Federal agencies that receive consumer or business checks at a point-of purchase location ("POP" entries), or via the mail or at a dropbox ("ARC" entries), to convert those checks to debit ACH entries if certain standard notice is provided by the agency. In contrast, the NACHA Rules do not allow for the conversion of checks drawn on business accounts for these applications due to operational and other difficulties associated with the processing of such transactions by financial institutions serving business customers with various types of loss-prevention/treasury management services.

A.1. Revised Accounts Receivable Disclosure

EastPay questions FMS' proposed shortening of the disclosure language for government ARC entries required of Federal agencies in Appendix C of 31 CFR Part 210. Until such time as check conversion through the ACH Network is a more widely understood process on the part of the consumer base in this country, EastPay would recommend that FMS take a "more is better" approach in terms of government ARC authorization. We believe that consumer education on check conversion is an area where FMS, on behalf of the Federal government, can continue to play a key role by actively reaching out to consumers making payments to Federal agencies. We would encourage FMS to view its agency disclosure language as one cost-effective opportunity to ensure this education is delivered. Customer education has been and will continue to be a critical part of the successful implementation of this product/service.

A.2. Expanded Accounts Receivable

FMS indicates that there are numerous activities where a Federal agency receives a check for payment or to cash (e.g., military payroll checks), but is not in a position to scan the check at the site of acceptance to initiate either a POP or ARC as currently defined in the NACHA Rules. FMS therefore proposes to expand its interpretation under 31 CFR Part 210 of what constitutes eligible acceptance of a check for conversion. Specifically, FMS indicates that the nature of several remote check acceptance activities resemble accounts receivable conversion, even if not technically embraced by the NACHA Rules. FMS therefore proposes to allow for the conversion of consumer checks to ARC entries, and business checks to CCD entries in these situations. The physical check would be destroyed rather than returned to the checkwriter.

EastPay recognizes the unique difficulties faced by Federal agencies in the types of payment scenarios described in the NPRM. We also believe that FMS has endeavored through its proposal to address these difficulties in a logical manner that is largely consistent with the requirements of the current NACHA Rules. However, with respect to business checks being converted to CCD entries, we believe that the problems already associated with business check conversion will be exacerbated and strongly oppose such a move. Moreover, as CCD entries, businesses and their financial institutions will experience significant difficulty identifying these important government entries from among traditional CCD entries. With the short timeframes for returning corporate ACH entries, the Receiving Depository Financial Institution ("RDFI") and the Receiver in these cases may not be in a position to make a return decision with respect to an entry's authorization in the proscribed timeframe.

A.3. Eligibility of Additional Instruments

The NACHA Rules specifically preclude certain types of checks from eligibility as source documents for ACH conversion applications due to operational difficulties inherent to their processing as ACH debits by the checkwriter's financial institution. Additionally, with several types of these checks, the holder of the check who is seeking to use it to purchase goods or services may not have legal authorization from the issuer of the check to assent to its conversion.
The NPRM proposes to revise the definition of a "Business check" that may serve as an acceptable source document for a Federal agency-originated ARC or POP entry to include:

(1) A check drawn on a corporate or business deposit account, including a third-party check,
(2) A credit card check,
(3) A negotiable instrument issued by a financial institution (e.g., a traveler's check, cashier's check, official check, money order, etc.), and
(4) A check drawn on a state or local government.[2]

As noted throughout our response, EastPay is very concerned about the impact this proposed change would have on financial institutions and their customers, and strongly oppose its adoption. Many of our financial institution members have already encountered problems when their official checks have been converted inappropriately. This issue has the potential to impact them severely since they are faced with accepting the converted item and possibly "violate" another regulation (e.g. Regulation D's limit of three third party withdrawals per time period) or return the item and create customer problems or inquiries.

Converting Business Checks – General Comment: We believe that converting more classes of business checks will exacerbate the problems associated with the current provision that allows for Federal agency conversion of business checks to ACH debits. Because many financial institutions have different processing streams for checks and for ACH transactions, the RDFI may not be able to post the ACH entry (e.g., the account may have a debit block or filter on the account, or the account number may have incorporated processing information in the form of additional digits that cannot be translated or parsed by the ACH processing system employed). Expansion of business check conversion by Federal agencies will result in significant reliance by the Federal government on demand drafts to collect on entries that cannot be posted to the Receiver's account as ACH entries, and will sour the public's appetite generally for electronic conversion.

At the same time, a check drawn on a business account that provides risk management or treasury management services may clear through the ACH processing system, but not be subject to the screening procedures that these services provide. This can, at a minimum, create account reconciliation problems for the business customer; at worst, it can allow an item that has been altered to be paid when the check processing system would have detected the discrepancy.

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2 Federal Register, August 21, 2003, p. 50677.

Operational Issues: As noted, the types of checks FMS proposes to make eligible for conversion are generally drawn on an account not controlled by the individual or company using the check to initiate payment. Therefore, the check issuer (e.g., a financial institution, company, credit card issuer, money order firm, money market mutual fund, etc.) is not in a position to assent to its check's conversion. This is an operational hurdle as well as a legal hurdle. When the RDFI receives the entry for processing and posting, the issuer and possibly the RDFI may dispute the item with respect to its authorization (provided there is sufficient time to review the entry) and returned it since, in this case, the issuer was unaware of the item's conversion. Moreover, if FMS then attempts collection via a demand draft, the Receiver may have instructions in place with its financial institution (the RDFI on the original ACH entry) to reject such items as not properly authorized. EastPay expects this will particularly be the case with money market checks, official and cashier checks, traveler's checks, and money orders. We have recently become aware of several financial institutions that have had fraudulent items presented using their official checks routing number and account numbers. Conversion of these types of items could significantly impact the financial institution ability to prevent these fraudulent items from posting. Separate systems and procedures will have to be developed and implemented.

Legal Issues: Generally, the types of checks FMS envisions as being included for ARC or POP conversion[3] are issued by a third party (e.g., a financial institution, a money order business, a money market, etc.) and therefore are not drawn on an account "owned" by the individual or business seeking to use the check. This poses several legal problems, including:

- The individual or business using the check for payment does not have the legal authority from the issuing party that owns the account to authorize the conversion of the item;
- The "authorization" to convert the check is not provided to the Federal agency by the holder of the account on which the check is drawn;
- The check frequently contains one or more physical security measures (e.g., watermarks, ink types, security threads, etc.) that are circumvented with conversion, and lost with re-creation as a demand draft.
- Issuers of some classes of items such as money orders will have difficulty proving compliance with state legal requirements that customers receive certain information (e.g., concerning payment of fees, expiration of the money order, etc.) without the original item or a full image of the original item.

EastPay believes that the sum total of implementing this proposed change would be:

- A significant increase in the number of ACH entries (and demand drafts) returned as Unauthorized -- a costly process to the RDFI and ultimately all ACH participants;
- Heavy reliance by FMS on demand drafts to collect on returned ACH entries, which will also either be returned unpaid or will be paid without necessarily the proper authorization in place;
- Friction between RDFIs and their check-issuing customers;
- Uncollected funds for the Federal government and debtor or late-payment status inappropriately conferred on the paying consumer or business; and,
- Legitimate questions being raised regarding the legality of such checks being converted.

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3 Or for a CCD under the proposed expansion of eligible items for remote lockbox/dropbox conversion.

For these reasons, we strongly encourage FMS to refrain from making these additional classes of checks eligible for conversion to ACH entries under 31 CFR Part 210.

A.4. Re-Presented Check Entry Service Fees.

FMS is proposing to reduce the authorization requirement for collecting service fees for returned checks that have been represented using the RCK application. Currently, consistent with the NACHA rules, 31 CFR Part 210 requires a Federal agency to obtain from the Receiver explicit authorization for the separate ACH entry used to collect the service fee. FMS is proposing to reduce this authorization to simple disclosure to the Receiver at the point where the original check was accepted for payment. Based on anecdotal data, there appear to be a number of corporate originators who are currently ignoring the NACHA rules to collect these fees without any consumer authorization. If FMS implements these changes, it may prompt others to engage in this practice. We have strong concerns that this could lead to a denigration of consumer confidence in the ACH network. Consumer "complaints" to state and federal regulators could cause the Federal Reserve Board's Consumer Affairs staff to revisit this concept of "notice = authorization".

To date, EastPay and NACHA have not viewed returned check service fee collection as a unique ACH application (a service fee can be collected using a PPD entry). Consequently, the Receiver's (i.e., original check writer) explicit authorization is required to initiate the entry. EastPay has not pursued the approach contemplated by FMS in the NPRM for service fees for returned checks due to the need to ensure that the consumer is informed and specifically assents to the transaction (see above comments re: ARC disclosure). Therefore, we strongly encourage FMS to continue to require Federal agencies to obtain the consumer's explicit authorization. Part of our concern is that this could lead corporate originators to adopt this approach and further degrade the consumer's confidence in the ACH network.

B. Reclamations

B.1. Mandatory Use of R15 or R14 Return Reason Codes

A financial institution is required to return any Federal benefit payment received after the institution learns of the death of the recipient. FMS notes in the NPRM that financial institutions typically return such payments using either an R02 (Account Closed), R15 (Beneficiary or Account Holder Deceased), or R14 (Representative Payee Deceased). FMS proposes to specify that only an R15 or R14 code be used to effect these returns. Further, an institution using an R15 or R14 return reason code would satisfy its obligation to notify the Federal agency of the death of the recipient, if the institution had not learned of that death directly from the agency.

While the proposal would seem to offer simplicity and clarity, several members have nonetheless advised EastPay that limiting returns to R15 and R14 for reclamations in the event of a death could be extremely problematic to the RDFI. For example, if a relative or executor of the deceased's estate closes the account, the RDFI's automated system will likely return subsequent entries to the account as R02 (Account Closed), and satisfy any need to inform an agency of the beneficiary's death through alternative means. If the RDFI is required to use R15 or R14 as proposed by FMS, some type of manual (i.e., costly) intervention on the part of the RDFI will be required.