



The Electronic Payments Resource™

October 16, 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 the Southwestern Automated Clearing House Association ("SWACHA") and its financial institution members, we respectfully submit comments in response to the notice of proposed rulemaking issued by the Treasury Department's Financial Management Service regarding proposed changes to Federal agencies' process for electronic check conversion. SWACHA currently represents over 1,000 financial institutions, the overwhelming majority of which are small and mid-sized, community-based banks, credit unions and savings institutions.

We have long supported the efforts of the Financial Management Service ("FMS") to bring consistency between 31 CFR 210 and the NACHA Operating Rules ("NACHA rules"). We are concerned, however, that these proposed rules would widen the gap between the NACHA rules and the attendant federal regulations and create a much wider dichotomy of regulation for our members. We are opposed to these proposed rules for the following reasons:

1. There would be a substantial increase in the cost to our members for processing Federal agency payments and create additional risks for handling of those payments.

2. Further divergence from NACHA rules would create confusion for consumers and companies about accepted private sector payments processing practices and the processing of payments by Federal agencies.
3. The proposed rules will undermine long standing industry practices concerning inspection of endorsements, create substantial new liability for financial institutions to their customers for absent or forged endorsements and diminish the rights of financial institutions regarding endorsements under existing Uniform Commercial Code Articles 3 and 4, as well as a significant body of case law.
4. The proposed rules would cause the unintended modification by regulatory fiat of agreements between financial institutions and their customers;
5. The proposed rules will create conflict between the proposed rules and other banking regulations, specifically the record keeping requirements of 31 CFR 103, Subpart C, Sections 103.33, 103.34 and 103.37.

Increased costs and regulatory burden – The proposed changes to electronic check conversion rules for Federal agencies will require financial institutions to incur costs associated with greater volume of exception items, particularly those items that are attempting to clear against a business account; legal disputes over appropriate authorization, systems changes to recognize and segregate Federal agency conversion entries for special exception handling, and customer service inquiries, complaints and dispute resolution. These costs would be borne totally by the receiving institution with no revenue possibility to offset the additional costs.

We also believe that FMS' proposed changes represent a "significant regulatory action," given the impact on consumers, businesses and financial institutions. Financial institutions will have to develop and deploy systems to identify Federal agency-initiated ACH entries drawn on business accounts so that appropriate reviews 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 such as cashier's checks, credit card convenience checks, money orders, state warrants, etc. would have to deploy verification systems to ensure that such checks were authorized for conversion by the maker, were properly payable, endorsed, and free from alteration.

We further believe that FMS has underestimated the costs and overlooked some of the costs 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. Further, presentment of demand drafts under several state laws carries substantially different warranties than those warranties associated with presentment of the original check and in some instances; the cost of preparing the paper replacement may be significant when compared to the cost of clearing the original item.

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 because the transaction was not conducted in accordance with the agreement between the financial institution and its customer.

Marketplace confusion – Check conversion through the ACH network and check truncation as envisioned 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 fully adapted to these new applications nor do they fully recognize their legal rights and responsibilities when a check is converted or truncated. We are concerned that, against this backdrop of rapidly evolving changes in payments, these proposals will create one more inflection point for confusion.

It is our position that the check collection processes that would be supported under Check21 when fully developed and deployed will offer much of the benefit that FMS is seeking through this proposed rule and all types of checks are eligible for truncation under the legislation. The use of images and substitute checks contemplated in Check21 can overcome many of the objections we have set forth below. We encourage FMS to refrain from adopting the check conversion proposals in this proposed rule and act instead to encourage rapid deployment of truncation under Check21 and use that new framework for the solutions that are being sought.

Inspection of endorsements – In order to preserve their rights and reduce their liability under Uniform Commercial Code Articles 3 and 4, financial institutions must be able to inspect the endorsements on their cashier’s checks. Conversion of cashier’s checks into ACH transactions will preclude a financial institution from examining their own instruments. Courts have held that financial institutions may recover from a collecting bank that received payment on a forged endorsement because the latter in collecting the cashier’s check has breached its warranty of good title. (See *Birmingham Trust National Bank v. Central Bank & Trust Co. Alabama 1973* and *Valley Bank & Trust Co. v. Zions First National Bank, Utah 1982*). Without the original item and the endorsements thereto, the issuing financial institution will not be able to assert its right to collect for a breach of warranty. The proposed rule does not address the issue of warranties to be made to receiving institutions for conversion of their cashier’s checks for missing, incomplete or forged endorsements and is an open question that must be addressed.

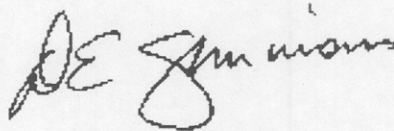
Customer agreements – The proposed changes have the potential to create conflicts between the agreements under which financial institutions provide treasury management services to their customers and how the transactions actually occur. We see this as an unintended consequence of the proposed changes. Customers of financial institutions expect their institution to follow their instructions regarding processing of payments. For example, converting a check that was issued by a business to a third party could directly conflict with the instructions given by the maker to the financial institution regarding positive pay files, payee verification, inspections of endorsements, and various other treasury management functions. Such a conversion would put the financial institution in the position of justifying the processing a transaction, over which it had no control, in direct contravention of its customer’s instructions; thus creating a significant customer service issue.

Conflict with other regulations – Conversion of financial institution official checks, money orders, traveler's checks and other monetary instruments into ACH transactions by FMS will cause the issuing financial institution to be unable to fully comply with the record retention requirements of 31 CFR 103 Subpart C, Sections 103.33, 103.34 and 103.37. The unavailability of the original monetary instrument will prevent the paying institution from inspecting the paid instrument and the endorsements thereupon for evidence of violation of various money laundering prohibitions.

SWACHA and its member financial institutions are committed to continuing to work closely with FMS as it attempts to address the many and varied challenges that FMS encounters daily to efficiently manage our nation's financial affairs. Elimination of the requirements for physical delivery of paper instruments to effect negotiation and the attendant costs thereto is a goal that is recognized and supported by this association and by our membership. We believe, however, that many of the proposed changes would cause our members to incur substantial costs for operational support for and compliance with these new processes; and we believe, on balance, that the overall societal benefits do not support these changes.

If you have any questions regarding these comments, please do not hesitate to contact the undersigned at (214) 953-4720.

Sincerely,

A handwritten signature in black ink, appearing to read "Dennis Simmons". The signature is written in a cursive, somewhat stylized font.

Dennis Simmons, AAP
President and Chief Executive Officer

Cc: SWACHA Board of Directors