

## How to Use This Manual

The payment systems landscape is constantly changing. New payment systems are emerging. At the same time, there are forces at work to make all systems converge. Some products, such as credit cards, wire transfers, cash transactions, and remittance instruments (e.g., cashier's checks), look pretty much the same as they did years ago even though they have increased in volume. In the last decade, some relatively new payment systems have soared in popularity; debit cards and stored-value cards are two of the best examples.

What about the venerable paper check? Many recent studies indicate that it is an instrument in decline. Yet the flow of paper checks through the bank collection system, though ebbing, continues to be huge (36 billion checks totaling \$40 trillion per year). More important, over the last decade, many checks issued by a drawer and payable to a payee have not really disappeared, but simply taken new directions as they entered the payment system. These new directions are accompanied by different sets of legal rules and compliance concerns. Checks are becoming part of the world of e-commerce.

This book focuses on important initiatives by the Federal Reserve Board, including (1) amendments to Regulation CC dealing with image exchange; (2) amendments to Regulation CC dealing with remotely created checks; (3) amendments to Regulation E dealing with electronic check conversation (ECK); and (4) revisions to Regulation J and Operating Circular No. 3.

We can identify at least five different directions that a check may take after it is issued by the drawer:

1. The check may be delivered to the payee, deposited, and collected as a standard paper cash item — the old-fashioned way. Yet collection as a paper item may now include an electronic presentment (ECP) feature, governed by the rules of the Electronic Check Clearing House Association (ECCHO).
2. The check may be remotely created by the payee, via telephone or the Internet, based on the drawer's MICR information, and then entered into the collection system as a paper check.

3. Using the MICR information on the paper check, the payee may convert the check into an ACH debit entry, so that it gets collected electronically under the rules of the National Automated Clearinghouse Association (NACHA).
4. The paper check may be truncated into a digital image early in the collection process, and then exchanged and presented electronically.
5. The paper check may be imaged, only to be reborn somewhere along the collection path as a paper “substitute check” under Check 21.

The purpose of this book is to describe these new directions and the different legal platforms that accompany them, then compare the systems from a variety of perspectives. Although the UCC has always governed check collection, we will see how federal law has become an ever larger overlay. In particular, Regulation CC was born in 1988 in order to (1) expedite availability of funds for the payee and (2) quicken notice of return. Then, in order to encourage image exchange, Regulation CC was expanded to provide the framework for substitute checks under Check 21. Now it has been expanded further, to govern remotely created checks under the New Federal Reserve Board rule, effective July 1, 2006. This evolution of Regulation CC reflects the new directions in check collection. A related development in this area is the expanding use of clearinghouse rules and private bilateral and multiparty agreements to provide the “law” governing both paper and electronic check collections. In this book, we analyze three examples of private rule-making: (1) the ECCHO rules governing ECP, (2) the NACHA rules governing ACH, and (3) deposit agreements governing the bank/customer relationship. This private rule-making is a form of deregulation that allows market players to establish their own collection rules. In turn, this has led to the emergence of a strong industry of third-party servicers.

Chapter 1 of this book looks at the overall payment systems landscape and where checks fit in that landscape. Chapter 2 analyzes the traditional legal framework for the collection of paper checks — Articles 3 and 4 of the UCC and Subparts B and C of Regulation CC. Chapter 3 looks at the ways check truncation (including imaging) is encouraged by the UCC. Chapter 4 focuses on electronic check presentment (ECP) under the ECCHO rules. Chapter 5 analyzes in detail the new Federal Reserve Board rule (effective July 1, 2006) governing remotely created checks. Chapter 6 examines the most important applications of check conversion to ACH debit entries — a development that has rocked the payments world over the last decade, continues to expand rapidly, and is now covered by the new Regulation E amendments (mandatory effective date of January 1, 2007). Chapter 7 discusses in detail the ACH and Regulation E rules governing electronic payments, including check conversions. Chapter 8 analyzes another direction a check

may take — truncation into a digital image, image exchange, then reconversion into a “substitute check” under the new Check 21 law. Since late 2004, the number of substitute checks has exploded. Chapter 9 discusses the interplay between Check 21 and various forms of check fraud, overdraft protection, and stop orders. Chapter 10 describes some of the legal issues that can arise when checks are made subject to “remote deposit capture” — a sea change in the way paper checks are being “electrified” at the earliest possible time. Chapter 11 provides a roadmap through the standard deposit agreement, suggesting terms and conditions that should be included in light of image exchange and other new directions that checks are taking.

Throughout the book, we seek to describe these new directions, analyze and compare the legal platforms, and offer compliance strategies. The target audience for this book is depository institutions, including banks, savings associations, and credit unions; bank customers, including retailers and billers; third-party service providers; treasury management personnel; clearinghouse organizations; consumer groups; and attorneys representing depository institutions and their customers.

The appendixes to this book include the text and legislative history of the Check 21 law; the updated version of Regulation CC (together with FRB Commentary) implementing Check 21 and the Federal Reserve Board regulation dealing with remotely created checks; relevant Federal Register materials provided by the FRB to help explain Check 21; flowcharts showing the movement of substitute checks, conforming to final industry standards approved on September 30, 2004; Subpart A of Regulation J; FRB Operating Circular No. 3; and additional materials regarding the FRB regulation governing remotely created checks. To aid the reader in accessing the content of this book, the materials are also published in CD format.

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