



Retail Payments Office

of the Federal Reserve System

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To: Chief Executive Officers at Depository Institutions

From: Rich Oliver
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Subject: Change in Federal Reserve Bank Operating Circular 3 Regarding the Reserve Banks' Handling of Electronically Created Payment Orders

We are writing to make you aware of an emerging concern in the marketplace for electronic collection and return of checks and a resulting policy change the Federal Reserve intends to make in our operating circular with respect to electronic transactions stemming from electronically created images.

The issue at hand involves a product being offered by certain vendors that purports to take Internet payment instructions for goods or services purchased from an Internet firm, convert them to an electronic "template", and then further convert the electronic template to an imaged check for clearing through the Fed or other check clearing networks. Our concerns are two fold.

First, we have become aware of instances in which such transactions result from fraudulent activities; that is, they involve web-based vendors or telemarketers who are engaging in fraud or in unfair or deceptive practices. Ordinarily, goods or services for which the consumer desires to pay via an electronic debit are cleared through the ACH network using a transaction code (WEB) that clearly indicates the nature and source of the transaction. The ACH network has in place regular and routine monitoring services through which the ACH operators and the originating financial institutions can monitor traffic and become aware of the presence of significant numbers of return items sent back by the paying customer as unauthorized.

By converting the payment orders to electronic check entries, however, the monitoring and awareness process is largely lost due to the technological and organizational limitations of the check clearing network. That is, there is no reasonable way to track returns by reason code and no central processing entity in a position to do the tracking even if it were feasible.

We would urge you to ensure that your business management and sales staff are aware that if you choose to use such payments services (Internet instructions to electronic check), for which you ultimately are the "endorser" of the item as the depository bank, you will be providing warranties and assuming liability for the legitimacy of the item. Consequently, as is the case with ACH and other payments relationships, it is imperative that you truly "know the customer" involved and the business they are in.

Second, as collecting banks with respect to electronic items captured from checks, the Reserve Banks operate in accordance with the requirements of the Check 21 Act and other applicable payments law and regulation. The Check 21 Act assumes that all Check 21 transactions begin with the original paper check item. When the Reserve Banks offer Check 21 clearing services, we endorse such items and accept applicable liability and make certain warranties that assume that the electronic item was captured from a check. The Check 21 legislation stipulates that all parties in the collection chain warrant to the next party in the clearing chain that the Check 21 transaction is an accurate image of the original paper check item.

Because the practice described above does not begin from an original paper item, but rather begins with an Internet instruction, the Reserve Banks cannot provide the warranty in question. Consequently, we are making changes to our Operating Circular 3, to be effective July 15, 2008, to indicate that a bank that sends us an electronic item will breach an express warranty to us if that payment transaction did not begin with a paper check item. In essence, we will look to the sending bank to make us whole if we suffer any loss because the sending bank sent us an electronic item that did not actually originate from a paper check.

Please note that we are not saying that all such transactions are inherently fraudulent or illegal. We are saying that the law of check collection does not support transferring, presenting, or returning electronically created images that were not originally captured from paper. It is our view that electronically originated consumer payments fall under the requirements of the Electronic Funds Transfer Act and Regulation E, not under check law. We will extract ourselves from potential liability for such items if they originated as Internet payment instructions, since we have no means of validating that the image sent to us for collection or return is an image captured from a paper check.

We hope this letter assists you and your staff in becoming aware of a growing industry practice and concern and alerts you to the impending changes to our operating circular. Please pass this on to appropriate parties in your payments and risk management areas so they may also be aware of these issues. Our revised Operating Circular 3 will be available for reference at our website, FRBservices.org, in the coming days. Thank you and please feel free to call your Federal Reserve account executive if you have any questions.