

## ACH-Image Convergence: Which Rules?

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The nascent push toward a hybrid payment format that uses both the automated clearing house and image exchange networks has already led to a pointed discussion of some operational hurdles that stand in the way.

Several of the bankers involved in the project participated in a conference call Wednesday, and high on their list of subjects was deciding which set of rules would govern the payments.

Because the transactions begin life as paper checks but clear over the ACH network, bankers may wind up subject to either check or electronic payment rules - and that decision could make a huge difference in how attractive the system is to banks.

Though most current electronic check formats use the Federal Reserve Board's Regulation E, which covers electronic payments, there are also precedents for using Regulation CC, which governs checks, and two lawyers said that using check rules would offer several advantages.

Danne Buchanan, an executive vice president at Zions Bancorp. and a member of the group that has started calling itself the "ACH-check coalition," said that Reg CC seems to be the favored approach.

"I think that would be the consensus of the group, although no decisions have been made," he said.

Oliver Ireland, a partner in the Washington office of Morrison & Foerster LLP, said in an interview that Reg CC is clearly the way to go. "The simple answer is, it's a check."

Brian W. Smith, a partner in the Washington office of Latham & Watkins LLP, said that banks have only three days to reject a check payment before it becomes final, but an ACH transaction may be open to dispute for 60 days.

When a check is converted to an ACH payment, the dispute period is extended, and the check could have "an unraveling effect two months later," he said.

And for checks that are converted into ACH files, banks must "worry about check kiting and all kinds of things that checks are susceptible to that ACH is not susceptible to," Mr. Smith said.

As a result, bankers may favor using Reg CC for the proposed system.

Deciding on the rules is "not an easy task, but it's not an impossible one," Mr. Smith said. "You have two parallel universes that are coexisting. The question is how to put them together."

The payment convergence issue burst on the banking scene last month, at the annual conference sponsored by Nacha, the electronic payments association.

The project is backed by four banking companies - Bank of America Corp., JPMorgan Chase & Co., Wells Fargo & Co., and Zions - all of which store their check images in the shared repository operated by Viewpointe Archive Services LLC of Charlotte.

The basic idea is that banks could use the ubiquitous ACH network to deliver information about checks to institutions that are not ready for direct image exchange. Doing so would enable banks that are ready to use images to settle payments electronically with those that are not, and it could reduce the volume of image replacement documents.

Under ACH rules, customers must be notified if a bank or merchant might convert a check into an ACH payment, and they must be given the opportunity to opt out of the process. Once a check is converted, it disappears from the check stream and is replaced by a new instrument, an ACH file.

However, under check law, a check can be converted into images, and back into paper as IRDs, at any time without consumer notice.

One of the key ideas behind the proposed system is that banks could convert checks into files that would clear over the ACH network but would remain checks. According to the lawyers, this means that check rules should apply.

This would make the proposed system different from current conversion formats, such as the widely used accounts receivable conversion format; the WEB format, for ACH payments that originate online; and the TEL format, for ACH payments initiated over the phone. All of those formats are governed by Reg E.

Merchants can also use the information provided by a customer through the TEL format to create a "demand draft," a paper item that functions just like a check and is covered by Reg CC.

Still, some transactions that run over the ACH network are governed by Reg CC. The best-known example is RCK, a format used for returned checks.

Mr. Ireland, a former Federal Reserve Board counsel, who helped draft Reg CC and the Check Clearing for the 21st Century Act, said the bankers hammering out the details for the proposed system could decide to use Reg CC, though it would likely require changes in Nacha's rules. "That wouldn't be the only way to do it, but it would be the easiest way."

Such an arrangement would also require agreements between individual participating banks, but the Uniform Commercial Code allows agreements like that, he said. "I don't think anybody has worked through the details, but I think this is an achievable result."

Mr. Smith, who was formerly the chief counsel for MasterCard International and the Office of the Comptroller of the Currency, said banks would be wise to use Nacha's

rulemaking process to make the decision, because that process, while stringent, is less laborious than those used by Congress and regulatory agencies.

"The last thing we want is another statute. Check 21 took a long time, and it takes forever to make amendments to Reg E," he said.

At the Bank Administration Institute's TransPay conference last month, John G. Feldman Jr., a senior vice president and the image transaction and payments executive at Bank of America, said he hoped the banks could begin a pilot test of a hybrid system this year.

Mr. Buchanan has been even more ambitious about getting a system up and running. Last month, he said a test of the proposed system could be up and running by August. However, last week he scaled back his prediction. "I think we can do it quickly, but I think it's going to take five or six months."

If the companies can resolve the legal and regulatory questions, the next step would be a proof of concept test with a bank outside Viewpointe, which plans to develop an image-on-demand capability for banks that do not use its archive.

If the proof of concept proves effective, Nacha's members would vote on whether to adopt the new format, and the organization would set an effective date, several months to a year in the future.