

Comments of the
National Consumer Law Center
On behalf of its Low-Income Clients
and
Consumer Federation of America
Consumers Union
National Association of Consumer Advocates
U.S. Public Interest Research Groups

Docket No. R-1226
Proposed Amendment to Regulation J
and
Regulation CC
Regarding Remotely Created Checks

These comments are submitted by the **National Consumer Law Center**,¹ on behalf of its low income clients, and the **Consumer Federation of America**,² **Consumers Union**,³ the **National Association of Consumer Advocates**,⁴ and the **U.S. Public Interest Research Group**,⁵ regarding the Federal Reserve Board’s consideration of improved protections for unauthorized remotely created checks. Remotely created checks (“RCCs), are *orally created*

¹ The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer laws, including Consumer Banking and Payments Law (2nd ed. 2002), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC’s attorneys have been closely involved with the enactment of all federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the federal agencies on the regulations under these laws. These comments are written by Margot Saunders, Managing Attorney of NCLC’s DC office and co-author of the Consumer Banking and Payments Law manual.

² The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers’ interests through advocacy and education.

³ **Consumers Union**, publisher of Consumer Reports, is an independent, nonprofit testing and information gathering organizations, serving only the consumer. We are a comprehensive source of unbiased advice about products and services, personal finance, health, nutrition, and other consumer concerns. Since 1936, our mission has been to test products, inform the public, and protect consumers

⁴ The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA’s mission is to promote justice for all consumers.

⁵ The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

checks, and are also known as telechecks or demand drafts. They are a problematic part of the payment system and their misuse by dishonest merchants have caused significant losses to consumers.

First, we wish to commend the Board for endeavoring to deal with the unreliability of RCCs, especially given the recognized problems with their fraudulent uses. This proposal by the Board appropriately encourages the consumer's⁶ bank to help protect the consumer from unauthorized RCCs. **We support the Board's current proposal.** However, we propose an additional— and far more effective — means to protect consumers from unauthorized RCCs. **We propose that the Board clearly articulate that RCCs originated by consumers are electronic fund transfers covered by the Electronic Fund Transfer Act.** Finally, in the alternative, given the extensive problems with RCCs⁷ we support the suggestion of the Attorneys General that RCCs be eliminated from the payment system.⁸

Remotely Created Checks Invite Fraud.

Scam artists routinely today take money out of consumer accounts through the use of RCCs. The technique can be perfectly legitimate—a party (the “payee”) obtains the consumer's advance permission to have money taken from the consumer's checking account to pay an obligation to that payee. Instead of a signed check, the payee presents to the bank an unsigned draft. The draft may look like a check, but, instead of a signature, has a notice stating “authorized by drawer,” “debiting of account authorized by customer” or similar language. The bank treats the draft like a signed check. This may be a convenient device where a consumer must make periodic payments to a lender, insurer, or merchant, because it allows for the automatic withdrawal of the amount due from the consumer's bank account without the consumer having to sign and mail each check.

The abuse occurs when a scam operator obtains the consumer's account number and bank's routing number (the “MICR” numbers on the bottom of the check) and presents a draft to the bank without the consumer's authorization. Once the scam operator obtains the relevant information, it can use desktop publishing technology to produce a check with the account information encoded on the bottom just as though it were the customer's own check. As a practical matter, neither the scam operator's bank nor the consumer's bank will review the signature block, but only the account information encoded on the bottom of the check.

⁶ We recognize – and support – that aspect of the proposal that would extend the transfer and presentment warranties for remotely created checks to business customers as well as consumers. We use the term “consumer” throughout these comments to refer to the owner of the checking account, for ease in terminology, and because we exclusively represent low income consumers who are people.

⁷ These problems are nicely articulated by the comments filed by the Attorneys General., which we strongly endorse.

⁸ The practical effect of banning RCCs altogether, as the AG's propose, is probably identical to our proposal to interpret coverage under the Electronic Fund Transfer Act. If RCCs are banned, then merchants have no choice but to use electronic transfers, covered by EFTA. If RCCs are permitted to continue, but clearly are required to comply with the EFTA, the effect is the same.

The scam operator may obtain the account information in a number of different ways. The merchant may tell the consumer that the account number is needed to deposit a prize the consumer has won.⁹ Some credit card finders use their service to discover the consumer's checking account number, and then electronically take money out of that account.¹⁰ The same is the case with credit repair organizations,¹¹ and companies that promise, for a fee, to find the consumer unused scholarships and grants.¹²

Other scam operators ask for a checking account number, to be used only when specified services have been provided, but then take money out of the account before providing the services and without authorization.¹³ Or the consumer can authorize a demand draft in a small amount, and then the merchant or debt collector can use the account number to withdraw larger or additional amounts beyond those authorized. The Internet also opens up many new opportunities for the deceptive identification of a consumer's bank account number. These are pressing problems for consumers who have had funds stolen from their bank accounts through both of these methods.

Remotely Created Checks Thwart Consumer Rights

The Electronic Funds Transfer Act gives consumers the right to revoke authorization for others to electronically access their bank accounts to make recurring payments. Some Internet payday loan companies use demand drafts or remotely created checks to thwart this consumer right. As described in a recent report by Consumer Federation of America,¹⁴ the business of making small cash loans via the Internet depends on electronic funds transfer, typically through the automated clearinghouse (ACH) system. Some lenders provide borrowers the right to withdraw authorization to electronically collect on loans, then bind consumers to the lender by converting the payment to a demand draft. For example, the United Cash Loans "Authorization Agreement for Preauthorized Payment" includes this statement:

You may revoke this authorization to effect an ACH debit entry to your Account(s) by giving written notice of revocation to us, which must be received no later than 3 business days prior to the due date of your loan. However, if you timely revoke this authorization to effect ACH debit entries before the loan(s) is paid in full, you authorize us to prepare and submit one or more checks drawn on your account(s) on or after the due date of your loan. This authorization to

⁹ FTC v. Windward Marketing, Ltd., 5 Trade Reg. Rep. (CCH) ¶ 24,223 (N.D. Ga. 1997) (proposed consent decree); Windward Marketing, Inc., 5 Trade Reg. Rep. (CCH) ¶ 24,060 (F.T.C. File No. X96 0026 June 21, 1996) (consent order).

¹⁰ See FTC v. Mandy Enterprises, Inc., 5 Trade Reg. Rep. (CCH) ¶ 23,181 (D.S.C. 1992).

¹¹ FTC v. Ellis, 5 Trade Reg. Rep. (CCH) ¶ 24,179 (C.D. Cal. 1996) (proposed consent decree).

¹² FTC v. Student Aid Inc., 5 Trade Reg. Rep. (CCH) ¶ 24,312 (S.D.N.Y. 1997) (proposed consent decree).

¹³ FTC v. Regency Services, Inc., 5 Trade Reg. Rep. (CCH) ¶ 24,219 (M.D. Fla. 1997) (proposed consent decree).

¹⁴ "Internet Payday Lending: How High-priced Lenders Use the Internet to Mire Borrowers in Debt and Evade State Consumer Protections," Consumer Federation of America, November 30, 2004.

prepare and submit a check on your behalf may not be revoked by you until such time as the loan(s) is paid in full.¹⁵

The Policy Behind The New Warranty.

As articulated by the National Conference of Commissioners on Uniform State Laws (NCCUSL)¹⁶ and others,¹⁷ the policy behind shifting the risk of loss of an unauthorized RCC from the payor bank to the depository bank is to encourage the bank whose customer has deposited the RCC to be more vigilant in its transactions with that customer. If the depository bank bears the loss from a significant number of unauthorized RCCs deposited by a specific customer, that bank will have the economic incentive to stop accepting RCCs from this customer. In this way, victims of unauthorized RCCs will be somewhat better protected from their continued use.

NCCUSL and the state legislatures of the fourteen states that have passed these changes to Articles 3 and 4 shifting the warranties and the risk of loss from unauthorized RCCs, and the Board by making the current proposal, have all implicitly recognized the inherent fraudulent potential of RCCs.¹⁸ These policy making bodies have also implicitly recognized that individual consumers are unlikely to be able to adequately protect themselves from the dangers of RCCs, and that the heavier hand of the financial institution facilitating the transfer of funds is necessary to protect against fraud.

The instant proposal may be strongly favored by the financial institutions themselves simply because of the uneven application of the new warranties under state law. While the desire for uniformity is an understandable justification for the extension of this rule to the remaining thirty six states, as well as to non-consumer transactions, the underlying problems with RCCs should be the real basis for any changes in the rules relating to them.

Indeed the necessity for the shift in the risk of loss is fairly obvious when one recognizes the huge changes in the legal and technological landscape since the seminal case of *Price v. Neal*.¹⁹ In the time of that case – and until fairly recently in the evolution of payment systems – it did make sense for the payor’s bank to bear the risk of loss from an unauthorized check. It was only that bank that could fairly evaluate the authenticity of the check and the payor’s purported signature, because the payor was its own customer. The depositor bank would presumably have no way of evaluating whether the check or the signature were as authentic. *However, until fairly recently, RCCs were not contemplated as a legal method of payment.* So the policy articulated by *Price v. Neal* was in furtherance of the logical analysis of how to best allocate the risk between the banks, and determined by which bank had the best means to protect itself from fraudulent checks. However, that policy was created for standard, handwritten, paper instruments – not for

¹⁵ United Cash Loans agreement on file with Consumer Federation of America.

¹⁶ See, e.g. http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-execminutes20801.asp.

¹⁷ See, e.g. http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/financial/2003-01_amendments-to-ucc.pdf.

¹⁸ In addition, the FTC has recognized the problems with these payment instruments by requiring express verifiable authorization from the consumer before an RCC can be used under the FTC’s Telemarketing Sales Rule. 6 CFR part 310.

¹⁹ 97 Eng.Rep 871 (K.B. 1762).

RCCs which do not originate with the payor, but with the payee. So as the Board has recognized, the payor bank has no means to even ascertain that a particular instrument is an RCC, let alone determine the authenticity of the signature. Thus, the same underlying policy which formed the basis for *Price v. Neal* – ensuring that the most appropriate party has the economic incentive to protect against fraud – is continued with this shift in the warranties as proposed by the Board.

This policy of establishing the risk of loss from unauthorized RCCs on the bank with the greatest ability to prevent them should remain the determining factor in the Board's method of addressing the problem. To carry that policy to its logical extension, one must also look to existing federal law – the Electronic Fund Transfer Act. This law, created to protect consumers in electronic transactions, also applies to RCCs. The Board should not limit itself to changes to Regs J and CC. The Board should also recognize that consumer originated RCCs are covered by the Electronic Fund Transfer Act.

Remotely Created Checks are Electronic Transfers Covered by the Electronic Fund Transfer Act.

We ask that the Board clearly articulate what a close reading of the statute reveals – that RCCs are electronic transfers covered by the Electronic Fund Transfer Act. Applying the Electronic Fund Transfer Act to RCCs will go a long way towards protecting consumers. First, any RCC which is not in fact authorized by the consumer would be an “unauthorized electronic fund transfer,”²⁰ a status which provides considerable protections to the consumer. So long as the consumer provides timely notice, the consumer's liability is limited to \$50 for an unauthorized transfer,²¹ the burden of proof is on the financial institution to prove the transfer is *not unauthorized*,²² and the consumer has access to the protections afforded by the error resolution procedure of the Act.²³ Moreover, if “recurring” transfers occur, written preauthorization is required before the transfers can occur.²⁴

The Board has already recognized that RCCs are electronic transfers, by referring to them as “electronic items” in the proposed regulations.²⁵ Moreover, they *are* electronic transfers – always initiated through a telephone call between the consumer and the merchant. The specific words of the Electronic Fund Transfer Act explicitly cover these transactions:

(6) the term “electronic fund transfer” means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or

²⁰ “Unauthorized electronic fund transfer means an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate the transfer and from which the consumer receives no benefit. ... 12 C.F.R SS 205.2(m).

²¹ 12 C.F.R. SS 205.6(b).

²² 15 U.S.C. SS1693g(b).

²³ 12 C.F.R. SS 205.11.

²⁴ 12 C.F.R. SS 205.10.

²⁵ “Electronic items” are referred to in proposed 12 CFR SS 210.5(a)(3) and 210.6(b)(2).

magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. (emphasis added).²⁶

The exception for checks or drafts does not provide an exemption for RCCs, as that exception is limited to “similar paper instrument(s).” The word “paper” modifies – and limits to this modification – the words “checks or drafts.” As a result, only *paper checks* or *paper drafts* are exempted from this definition of electronic transactions.

One might argue the exemption for paper checks or drafts does apply because a paper instrument is used in the process of transacting of the payment, as the *merchant* creates a paper version of the draft and uses it to deposit the draft into its bank. However, by the terms of the statute, for a payment to fit into the exception, it must be a *transaction initiated by a paper check or draft*. The transaction therefore must be *started* by the consumer with paper. As the merchant’s creation of the paper is not the *originating* activity, so that the transaction is not *originated by a paper instrument*. As the courts have noted in the only cases interpreting the coverage question, the focus is on *the activity of the consumer* when the transaction is first initiated.²⁷ In the case of RCCs, these are transactions which are initiated by a telephonic communication between the consumer and the merchant, not by the merchant’s filling out a draft or check.

Similarly, the exception to coverage for some transfers of funds which are initiated via a telephone does not provide respite for RCCs. This exception is limited to –

(E) any transfer of funds which is initiated by a telephone conversation between a consumer and an officer or employee of a financial institution which is not pursuant to a prearranged plan²⁸

The language of both the Act and the Board’s implementing Regulation E limits the exemption for telephone electronic transfers to conversations between the consumer and the *financial institution*. This is the implicitly the financial institution which holds the consumer’s money. Conversations over the telephone between the consumer and the *merchant* to initiate the transfer of funds from the consumer’s account *at a financial institution* to the merchant are nowhere excluded.²⁹

²⁶ 15 U.S.C. SS 1693a(6).

²⁷ See e.g. *Wachter v. Denver Nat’l Bank*, 751 F. Supp. 906 (D. Colo. 1990) (A bank’s use of an electronic device merely to process a transaction internally does not constitute an electronic fund transfer within the meaning of the Electronic Fund Transfer Act, but rather the Act’s focus is upon consumer-initiated or consumer-authorized transfers where electronic devices are utilized in place of face-to-face banking transactions, and thus presence of personal contact with bank personnel who intercede between a consumer and electronic device used to facilitate a transaction removes that transaction from the scope of the Act); *Spain v. Union Trust*, 674 F. Supp. 1496 (D. Conn. 1987) (transaction consisting of teller preparing a debit slip which is processed electronically is not covered by Act).

²⁸ 15 USC 1693a(6)(E) and 12 CFR 205.3(c)(6).

²⁹ Moreover, we would point out that if the merchant happens to be a financial institution, but is not the institution which holds the consumer’s bank account, that would be simply coincidental, and would not make the exemption apply.

Congress declared that the purpose of the EFTA is “to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. The primary objective of this subchapter, however, is the provision of individual consumer rights.”³⁰ Congress provided the Board discretion in its regulatory powers under the Act – so long as the Board’s judgment determines the regulations “are necessary or proper to effectuate the purposes of this title, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.”³¹

The current state of the law and technology creates the absurd dynamic where a recipient of a payment made over the telephone from a consumer has the option to choose which law it would prefer to have the transaction governed by – the UCC or the EFTA. The activity of the consumer is identical in both scenarios. The consumer makes the decision to allow the recipient to take a specified amount of money out of the consumer’s bank account. The recipient asks for and then receives either 1) the information necessary to create a RCC – and have the limited protections of the UCC applicable to checks and drafts apply to the transaction, or 2) the information necessary to electronically debit the consumer’s bank account – providing the consumer with the enhanced protections from unauthorized transfers and access to the error resolution provisions of the EFTA.

It is not good for the banking system in general to have such stark non-uniformity in rules based on imperceptible differences. The extreme complexity and irrationality of the rules governing different payment methods surely adds costs to the U.S. payment system and reduces public confidence in it and understanding of it. Furthermore, the very existence of a payment method – such as RCCs – that facilitates fraud also reduces confidence in the U.S. payment system and adds unnecessary costs.

The activity of the consumer is identical in both situations – the transaction is originated through a telephone call. The protections provided to the consumer are significantly different. It was clear that Congressional intent in creating the EFTA was to ensure that consumers are protected in electronic transactions – primarily because they would not have the certainty and proof of intent that paper provides to a payment transaction.³²

Conclusion

The problems of fraudulent and unauthorized RCCs have been well documented in the letter sent by the Attorneys General, and substantiated by the additional protections required by the FTC when RCCs are used in telephone solicitations.³³ The current proposal of the Board to shift liability for unauthorized RCCs to the depository bank is very good, and will go part way to reducing the ongoing problems of RCCs. However, there is another law that already applies to

³⁰ 15 U.S.C. § 1693(b).

³¹ 15 U.S.C. SS1693b(c).

³² Similar thinking was evident in Congressional intent when it required a comprehensive scheme to assure real assent and accessibility in electronic transactions by consumers in the consent provision in E-Sign. *See* 15 U.S.C. SS 7001(c).

³³ 16 C.F.R. § 310.3(a)(3).

the EFTA which provides enhanced protections to consumers under it – the Electronic Fund Transfer Act. The Board should use the authority given it by Congress to expressly articulate the application of the EFTA to RCCs. In the alternative, the Board should adopt the suggestion of the Attorneys General and ban RCCs altogether.

While RCCs might in the past have been considered a sufficiently valuable convenience to justify their risks, this is no longer the case. Consumers who need to make last minute payments are now able to authorize an electronic debit from their account by telephone, with all the protections associated with the EFTA. The continued allowance of RCCs without these protections simply facilitates fraud. The Board has several mechanisms at its disposal to close this hole in the payment system. Clarifying that the EFTA applies to RCCs is one responsible and appropriate method of addressing the ongoing problem of RCCs.