



August 24, 2021

Via Electronic Submission

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: **Proposed Changes to Regulation J (FRB Docket No. OP-1750)**

Dear Ms. Misback:

The Clearing House Payments Company L.L.C. (TCH) appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System (Board) about its proposed amendments to Regulation J.¹ These amendments would make certain technical changes to subparts A and B and add a new subpart C to support the future FedNowSM service. TCH provides these comments as the operator of the country's first 24x7, end-to-end, real time inter-bank payment system, the RTP[®] system, which we launched in 2017. Our comments focus on aspects of the proposed amendments that may impact the competitive parity between the RTP System and the future FedNow service. Our comments do not address issues or concerns that TCH's member banks may have as potential participants in the future FedNow service.

As further explained below, we request that the Board

- Acknowledge in the supplementary information to the final amendments that (i) application of Uniform Commercial Code Article 4A (Article 4A) to consumer transfers is not the only means of providing a consistent, predictable, and clear legal framework for payment systems designed to support both commercial and consumer payments and (ii) private sector payment system rules and contracts that incorporate Article 4A with respect to commercial payments and address the rights and responsibilities of participants with respect to consumer payments are an equally valid and effective means of providing a consistent, predictable, and clear legal framework;
- Revise its competitive impacts analysis by recognizing that private sector operators do not have the ability to issue federal regulations and that the FedNow service will consequently be able to bind remote parties and address creditor process issues with respect to EFTA payments in a way that private sector systems cannot; and

¹ 86 Federal Register 31376 (June 11, 2021).

- Perform and publish for public comment a second competitive impact analysis before an operating circular is finalized to support the FedNow service.

Discussion

1. Application of Article 4A to consumer transfers is not the only way to have a clear and consistent legal framework

The Board notes in the supplementary information to the proposed amendments that one of the differences between the Fedwire[®] Funds service and the FedNow service is that the Fedwire Funds Service is designed to serve primarily as a large-value funds transfer system between financial institutions whereas the FedNow service is designed to accommodate consumer payments.² Because the Fedwire Funds Service serves primarily as a wholesale payment system, Fedwire funds payments that include a consumer originator or consumer beneficiary are not subject to EFTA or Regulation E.³ In contrast, as the Board notes, FedNow payments that involve a consumer originator or consumer beneficiary “could potentially be subject the EFTA”⁴ since the FedNow service is not the kind of service that is excluded from Regulation E’s definition of electronic funds transfer; it is not a wholesale system. Hence, absent action by the Board in its regulations, consumer payments over the FedNow service would not be subject to Article 4A.⁵

Because Article 4A provides an end-to-end framework for funds transfers and addresses issues that can arise between banks, and EFTA and Regulation E only address issues as between a consumer and his or her bank, the exclusion of transfers involving a consumer originator or beneficiary (“EFTA payment”) from Article 4A creates a “gap” with respect to the rights and responsibilities as between banks involved in the transfers. TCH faced this same issue when developing the legal framework for the RTP system since the system was not primarily designed to be a wholesale system. Hence, commercial RTP payments are subject to Article 4A whereas EFTA RTP payments are not.

TCH addressed the gap for EFTA payments within the RTP Operating Rules by including rules that were equivalent to key Article 4A provisions, such as rules defining when a RTP Sending Participant’s obligation to pay the RTP Receiving Participant for a RTP Payment arises, how the payment obligation is satisfied, and when a RTP receiving Participant is obligated to refund payment for an RTP Payment that is not completed.⁶ TCH then ensured that the rules would apply to banks using the RTP system by having each participant agree to the RTP Operating Rules. The approach used by TCH with respect to the RTP

² 86 Federal Register 31378.

³ 12 CFR § 1005.3(c)(3) (excluding from the definition of an electronic funds transfer “any transfer of funds through Fedwire or through a similar wire transfer system that is used primarily for transfers between financial institutions or between businesses.”).

⁴ *Id.* We believe that in fact most FedNow payments involving consumer originators or consumer beneficiaries will be subject to EFTA as only transfers from or to non-asset consumer accounts or trust accounts would fall outside the scope of Regulation E. See, 12 CFR § 1005.2(b) (definition of account) and § 1005.3(a) (“This part applies to any electronic funds transfers that authorizes a financial institution to debit or credit a consumer’s account.”).

⁵ UCC Article 4A-108. There is a limited exception to the exclusion of consumer transfers from Article 4A coverage if the only reason a payment is governed by EFTA is because it is a remittance transfer.

⁶ These rules are equivalent to UCC Article 4A-402.

system is similar to the approach used by both TCH and the Federal Reserve with respect to the ACH network and the operations of EPN and FedACH.

The Board has proposed a different approach to addressing the gap for FedNow payments that are also EFTA payments. It proposes to incorporate Article 4A into Regulation J (as it has previously done for the Fedwire Funds service)⁷ and to override the state law scope of Article 4A by applying it (except to the extent of any inconsistencies with EFTA) to EFTA payments. While TCH takes no position on this approach for addressing the gap, it does object to the Board's suggestion that unless Article 4A is made to apply to consumer payments "a number of important aspects with respect to consumer transfers over the FedNow Service could potentially lack clear and consistent rules"⁸ and similar statements.⁹ TCH believes these statements may be misunderstood by the public and, in particular, depository institutions that are interested in joining the RTP System, to mean that the FedNow service has a superior legal framework to that of other systems.

While TCH understands that it is convenient for the Board to change the scope of Article 4A for the FedNow service,¹⁰ to ensure a level playing field between the FedNow service and the RTP system, it is important that the Board acknowledge in its final rule that there are other ways to address the gap that are equally effective.¹¹ Ideally the Board would note both the approach taken in the ACH network and

⁷ The Board incorporated Article 4A in Subpart B of Regulation J in 1990 and applied it to the Fedwire Funds Service in order to (1) provide "a more comprehensive set of rules for funds transfers involving Federal Reserve Banks" than the existing provisions in Regulation J; (2) make Subpart B consistent with state laws applicable to funds transfers as states began to adopt the article; and (3) help to ensure that "Federal Reserve Banks compete on an equitable basis with private-sector providers of funds-transfer services." 55 Federal Register 40792 (October 5, 1990). *But see infra* note 11 (discussing the difference between how the Board incorporated Article 4A into Regulation J for the Fedwire Funds Service with how it proposes to do so for FedNow).

⁸ 86 Federal Register 31378.

⁹ The Board also states that incorporation of Article 4A and its application to consumer payments "is necessary to ensure that the law applicable to all transfers over the FedNow Service is consistent, predictable, and clear" (86 Federal Register 31377) and "to provide a clear, consistent, and comprehensive set of rules for all funds transfers over the FedNow Service, consistent with the EFTA and the purposes of UCC Article 4A" (86 Federal Register 31378).

¹⁰ TCH recognizes that addressing the "gap" is simpler the fewer banks that are involved in a consumer transfer. The RTP system only involves two banks, the RTP Sending Participant and RTP Receiving Participant and, thus, its rules do not have to account for intermediary banks. In contrast, the future FedNow service will include one or more Federal Reserve Banks in addition to the FedNow Senders and Receivers. And, while the proposed Regulation J amendments do not permit FedNow payments to be sent to a FedNow Receiver for further credit to another bank, they are silent as to whether a FedNow Sender must be the originating bank of a FedNow payment. Hence, it appears that there could potentially be other banks prior to the FedNow Sender.

¹¹ We note that the Board took a different approach in Subpart B. Although funds transfers over the Fedwire system were excluded from EFTA in 1990 when Article 4A was incorporated into Regulation J, the Board considered the possibility that one portion of a funds transfer could be sent through Fedwire and another portion of the same transfer transmitted in a way that made the other portion subject to EFTA. While it is unclear how this could be the case given the clear exclusion from EFTA of funds transfers through Fedwire, in 1990 the Board believed that there could be a scenario in which 4A-108 would have the effect of excluding a funds transfer through Fedwire from Article 4A. Rather than use its federal authority to say that Article 4A would apply to the entire funds transfer in such scenarios, the Board tailored Regulation J so that Article 4A would apply to the Fedwire portion of the funds transfer but not to the portion governed by EFTA. The Board took this approach "to ensure that the rules for all funds transfers through Fedwire are consistent" but did not suggest, as it does in the current Regulation J proposal, that without application of Article 4A to consumer payments a number of important aspects of the payments would lack clear and consistent rules. 55 Federal Register 40792 (October 5, 1990).

the approach of TCH in its RTP rules as examples so as to avoid any unintended consequences to these networks. To this end TCH notes that the Federal Reserve determined as part of its approval of the RTP joint account under the Board's Final Guidelines for Evaluating Joint Account Requests that the RTP system has "demonstrate[ed] that it has a sound legal and operational basis for its payment system."¹²

2. Private sector operators cannot use federal preemption to apply Article 4A to EFTA payments

The Board concludes in its competitive impact analysis that it "does not believe that the proposed amendments to Regulation J will have a direct and material adverse effect on the ability of other service providers to compete effectively with the Reserve Banks in providing similar services due to legal differences."¹³ In explaining its rationale for this conclusion the Board states that the proposed amendments "do not include provisions that a private-sector provider of similar services could not also adopt to similar effect through rules or operating procedures."¹⁴ TCH disagrees with this statement.

As noted in section 1 above, Article 4A does not apply to any funds transfer any part of which is subject to EFTA and Regulation E. In sharp contrast to consumer transfers over the Fedwire Funds Service and TCH's CHIPS system that do not get the benefit of EFTA coverage by virtue of the scope of EFTA, consumer transfers over FedNow and the RTP system will be subject to EFTA and, therefore, excluded from Article 4A coverage. It is for this exact reason that the Board feels a need to enact federal law to supersede the state law exclusion in Article 4A. Private sector entities like TCH cannot enact laws. Instead, TCH is limited to those actions that it can take through contract.

The practical consequence of this difference between the Board's adoption of Article 4A as a federal regulation that governs all FedNow payments and TCH's use of 4A-like provisions in the RTP rules to address EFTA payments over the RTP system is that TCH cannot achieve the same reach over remote parties with its legal framework, which relies on privity of contract, as the Reserve Banks will have with Regulation J. Specifically, the Board has proposed that Regulation J bind remote parties as if the regulation was a funds transfer rule. This means remote parties do not need to sign agreements to be subject to Regulation J's rules but can be bound as long as they know that the FedNow service may be used to affect their payment.¹⁵ As noted in the commentary to Article 4A, "The ability of a funds transfer system to make a choice of law by rule is a convenient way of dispensing with individual agreements and to cover cases in which agreements are not feasible."¹⁶

Because Article 4A does not apply by its terms to EFTA payments over the RTP system, TCH cannot simply rely on the provision in Article 4A that permits funds transfer system rules to bind remote parties without contracts. Given the clear state law exclusion of EFTA payments from the scope of Article 4A, it is questionable whether a court would allow this special statutory rule, which was intended to apply to

¹²Principle 2, Guidelines for Evaluating Joint Account Requests, *available at* https://www.federalreserve.gov/paymentsystems/joint_requests.htm.

¹³ 86 Federal Register 31382.

¹⁴ *Id.*

¹⁵ UCC 4A-507(c). ("A funds-transfer system rule may select the law of a particular jurisdiction to govern . . . the rights and obligations of some or all parties to a funds transfer any part of which is carried out by means of the system." Such a choice of law is binding on parties beyond banks that participate in the system so long as those parties have notice that their funds transfer may be carried out through the system and the parties have not made a different choice of law selection by agreement.)

¹⁶ Comment 4, UCC 4A-507.

commercial payments, to govern EFTA payments over the RTP System. Hence, any contractual agreement between TCH and RTP participants to apply Article 4A to EFTA payments likely could not affect the rights of remote third parties with respect to such EFTA payments as such payments are outside the state law scope of Article 4A. As a result, the RTP System requires a clear chain of contracts to ensure end to end coverage of its rules to EFTA payments. This chain of contracts is more burdensome to implement and maintain than the Board's proposed approach for the FedNow service.

In addition to being able to bind remote parties to EFTA payments with less burden than TCH can, the Reserve Banks will also have the benefit of Article 4A's creditor process provisions for EFTA payments. Because these provisions impact non-parties to funds transfers (creditors of an account holder) and are the "exclusive means"¹⁷ of determining how creditor process applies to funds transfers, the Reserve Banks will be able to rely on the status of Regulation J as a federal regulation and 4A's rules to address the issue of creditor process with less effort than TCH can for the RTP System. While TCH has addressed the issue both in the design of the RTP system and in its legal framework, it will not have the same ability to simply rely on Article 4A if creditor process issues arise with respect to EFTA payments over the RTP system.¹⁸

TCH does not take issue with what the Board has proposed except to say that we do not believe private sector rules could do the same and that the FedNow service may derive some competitive advantage from the difference. Hence, we believe the Board needs to revise its competitive impact analysis to more closely consider the impact of using its federal authority to apply Article 4A to EFTA payments over the FedNow service.¹⁹

3. The Board should conduct an additional competitive impact analysis and seek public comment on the analysis before it finalizes an operating circular to support the FedNow service.

Because operating circulars provide much more detail about the Federal Reserve services than Regulation J, it is difficult for TCH and other members of the public to determine the degree to which the legal framework for the FedNow service may have a direct and material adverse effect on the ability of other service providers to compete effectively with the Reserve Banks in providing similar services. Hence, TCH requests that the Board conduct a second competitive impact analysis once the proposed operating circular has been drafted and allow for public comment on the second analysis before the Board finalizes the operating circular to support the FedNow service.

¹⁷ The official comment to UCC 4A-102 states that the rules of the article "are intended to be the exclusive means of determining the rights, duties, and liabilities of the affected parties in a situation covered by particular provisions of the Article." This comment is often cited by courts when parties in litigation seek to apply other principles of law to issues addressed by Article 4A.

¹⁸ TCH has addressed the risk of creditor process interrupting an RTP payment by using a special deposit account to hold funds that back up positions on the RTP ledger.

¹⁹ In 1990 the Board determined that Subpart B should have the same scope as a funds transfer system rule despite the fact that as a federal regulation Subpart B could govern all parties to a funds transfer through Fedwire. In making this decision, the Board recognized that a private sector operators could not achieve "end-to-end coverage for their funds-transfer system rules through federal regulation." 55 Federal Register 40793, 40794. Further, among the reasons the Board gave for having a consistent scope with private sector funds transfer system rules the Board stated that it did not believe that there was a "compelling case for achieving added certainty for transfers through Fedwire as opposed to transfers through other funds-transfer systems or book transfers." 55 Federal Register 40794.

Thank you for your consideration of these comments. If you have any questions or wish to discuss this letter, please do not hesitate to contact me.

Yours very truly,

A handwritten signature in black ink that reads "Alaina Gimbert". The signature is written in a cursive, flowing style.

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