



INDIANA UNIVERSITY  
MAURER SCHOOL OF LAW  
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Federal Reserve Financial Services  
Federal Reserve Banks of Cleveland, Chicago & Kansas City  
The Federal Reserve Bank of Cleveland  
1455 E 6th St,  
Cleveland, Ohio 44114

Via: [comment@fedpaymentsimprovement.org](mailto:comment@fedpaymentsimprovement.org)

Re: Comment on September 2013 Public Consultation Paper on Payment System Improvements and Responses to Questions Posed

Dear Presidents Pianalto, Evans, and George:

Thank you for inviting my comments on Federal Reserve Financial Services Public Consultation Paper on Payment System Improvements. I appreciate this opportunity to comment and commend the professionals on your staffs that created the Paper.

I agree that leadership by the Federal Reserve Banks (“Reserve Banks”) is vital in this field, particularly because business-to-business collaborations can run afoul of our federal and state antitrust and unfair and deceptive trade practice laws. In other words, the Reserve Banks are able to and should play a role in fostering development of new products because of their ability to play a facilitator’s role in the delicate balance between collaboration and competition in the payments networks industry, even as they play a role as a provider of financial services themselves.

My comments are based on my experience teaching payments law over the past 25 years, on participation in symposia focusing on payments law innovations including four payments innovations symposia sponsored by Federal Reserve Banks over the past dozen years, and work on behalf of the Uniform Law Commissioners and American Law Institute on payments issues over the past ten years, primarily as the reporter to a Payments Study Group on Check 21 and as an elected member of the ALI. Prior to joining the faculty at the Maurer School in 1989, I worked at the Federal Trade Commission on consumer credit and payments issues from the mid-1970s to the late 1980s. During this period, I was assigned to work, from time to time, on matters over which the Board of Governors had regulatory authority including implementation of the Expedited Funds Availability Act of 1987 and Regulation CC and, earlier than that, on the Truth in Lending Simplification Act. In addition, I also have published numerous articles on emerging electronic payments, including on mobile payments and virtual currencies, since 1996. Also, I have been a co-author of the volume of the Hawkland Series treatise on the UCC that deals with non-UCC payments since 2008.

My comments do not reflect the views of the Indiana University Maurer School of Law or of the Trustees of Indiana University.

In this comment, I first make a few general observations about contemporary issues in payments and payments law. Next, I note a few issues in the paper that require special attention as work progresses in improving payment systems, whether in industry sectors or more generally. And, finally, I offer responses to the specific questions raised in the Consultation Paper, as well as a brief conclusion.

## I. General Observations

The most glaring omissions in the consultation paper involve its lack of attention to:

- the legal mandate that the Reserve Banks have to effect change,
- the legal regimes that are and will continue to grow around new payments systems of the types that are currently in use and regulated in the United States,
- the (legal) externalities that current and emerging new payments systems may cause, and,
- the paucity of focus on ensuring that emerging payments systems operate with reasonable, transparent pricing for products, particularly for those offered to consumers. The trend in emerging payments systems for higher pricing or pricing structures in which different participants may claim shares of the payment along the path the payment travels looks like a return to pre-Federal Reserve System non-par banking, which has the potential to harm consumers and small businesses and to harm the least affluent in both categories the most. The value of transparent and reasonable pricing can be seen in the report of the September 2013 study by economists from the University of Chicago and New York University on the Credit CARD Act of 2009, and the study's estimate that cost disclosures have saved consumers using credit cards upwards of \$20 billion since the Act became effective.<sup>1</sup> Another recent study by the Federal Reserve Bank of Kansas City suggests that the Durbin Amendment has produced more "free checking" opportunities for consumers than experts predicted.<sup>2</sup>

As my general observations and comments on many of the specific questions posed will demonstrate, the lack of clear legal regimes for emerging payments systems is a major obstacle to their adoption and has the potential to cause significant legal

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<sup>1</sup> Neale Mahoney & Johannes Stroebel (with Sumit Agarwal & Souphala Chomsisengphet), *Regulating Consumer Financial Products: Evidence from CreditCards*, (Sept. 2013, <http://bfi.uchicago.edu/news/lower-fees-without-higher-rates> (last visited Dec. 12, 2013). This paper also is available at [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2330942](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2330942).

<sup>2</sup> See generally, <http://www.kansascityfed.org/publicat/econrev/pdf/13q4Sullivan.pdf>.

externalities for individual and small business users of payment systems.<sup>3</sup> I encourage the development of a robust array of new payments instruments or options that are versatile even at the expense of not being universal and that offer real choices to wholesale and retail users to attract customers not only on the basis of pricing, clearing, and settlement timing, but also on features including legal protections (error resolution, well-laid out, reversal opportunities, and privacy) and strong data security. Real legal protections can help consumers avoid problems identified by the Federal Trade Commission over the past decade and longer that resulted in its proposed ban on certain payments products used by sellers and telemarketers.<sup>4</sup>

#### A. Obstacles to Achievement of Change in Payments Systems.

I agree with the principal that ubiquitous, open payment networks, or broadly interoperable payment networks, are generally worthy goals. Among the current obstacles to achieving either ubiquity or broad interoperability are:

- (1) a lack of willingness on the parts of smaller banks and depository institutions to support electrification of payments generally, in part because of the expense involved in operating back-room systems and in transforming from current systems to emerging payments systems;
- (2) a lack of transparency on pricing for end-users, particularly consumers and small businesses;
- (3) a lack of transparency for individuals (and possibly small businesses in terms of the manner in which certain payments they make or receive are processed and the legal rules, including recourse rules, applicable to different forms of payments, and confidentiality/ privacy of their payment information and transactional choices);
- (4) wide variations in authentication protocols and error resolution opportunities among existing payments systems and the paucity of rules for error resolution in certain mobile and other Internet-based payments options;
- (5) a lack of control by the issuer/ sender/ obligor over the manner in which checks are processed and a consequent lack of ability to appreciate legal risks associated with choices among payment options (checks, pre-authorized ACH credits/ pushes, credit, debit, and prepaid);
- (6) concerns raised by state attorney generals and federal bank regulators that some payments processors and others are not abiding by laws that exist for the protection of individuals, including laws regulating certain forms of credit and payments products;

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<sup>3</sup> The externalities I am considering here include the difficulty of accessing reasonable dispute resolution opportunities or the costs of accessing such opportunities relative to the value of the transaction in issue.

<sup>4</sup> See Federal Trade Commission, Telemarketing Sales Rule, 78 Fed. Reg. 41200 (July 9, 2013) (proposed ban on use by sellers and telemarketers of remotely created checks, remotely created payment orders, cash-to-cash money transfers, and cash reload mechanisms).

- (7) a need to develop a legal framework for new payments systems, not just the economic framework, to encourage early adoptions and help smaller users cover the expenses of migrating to the newer systems; and
- (8) a chicken-and-egg problem of determining how to regulate payments products that are only a twinkle in the developers' minds and that may rise or fall for funding reasons or the perceived difficulty of complying with other regulatory requirements before a sufficient penetration of the market occurs.

#### B. Control of Access to Clearing and Settlement Systems by Trusted and Supervised Entities

Additionally, innovators in payments have asserted that all providers should have direct access to payments clearing and settlement systems. At the September, 2013 symposium held at the Federal Reserve Bank of Chicago, an advisor to mobile payments providers asked President Pianalto whether the United States would follow the lead of Brazil and allow non-depository providers direct access to the banking systems. (I regret I did not recall President Pianalto's precise response to this question.) But let me say that, given problems currently being associated with sponsors of WMD proliferation, narcotics kingpins, offshore and tribal lenders, online gaming interests, and certain non-depository credit providers and payments processors, I do not favor giving non-depository providers and processors direct access to settlement and clearing systems at this time – even though I value the new products and enhanced competition non-depository providers bring to the payments arena. For the mid-term at least, someone – the Board in its over-arching regulatory role or the Reserve Banks in their operational roles – must continue to play the gate-keeper role in the clearing and settlement systems, effectively of vetting and vouching for those who require clearing and settlements. Longer term, however, because of innovations such as virtual and crypto-currencies, one can imagine a time when clearing and settlement systems will undergo larger changes, perhaps building upon the newer roles played by private sector actors such as PayPal in clearing and settling certain transactions. When these larger changes happen, it may be time to re-calibrate to give greater access to clearing and settlement systems to certain non-depository players, without necessarily abandoning all current Board and Reserve Bank gate-keeping responsibilities in payment system security and integrity. And it may not be time for this drastic a change.

#### II. Additional Observations about Gaps and Opportunities

Turning to the discussion of gaps and opportunities on pages 3&4 of the paper, I would like first to agree with the October 24, 2013 comment submitted by Bruce J. Summers that the discussion of gaps and opportunities focuses too little on end-users generally, and really very little on consumers and small businesses. In particular, I agree that future consultations should focus on credit transfer payments processes used in nearly every other developed economy. The credit transfer model addresses many of the near-real time issues raised and also provides the initiator of the payment a potentially

greater degree of controlling the manner, timing and pricing of the payment than many of the models raised in the paper appear to offer.

Beyond that, I would make the following additional observations about specific issues identified using a numbering system that coincides with the numbering in the paper:

- (1) Checks have legal protections that are not available in other payments systems beyond ubiquity and convenience. Primary among these for many B2B transactions is the very old-fashioned, but useful doctrine of satisfaction and accord. Current Uniform Commercial Code section 3-311 sets forth specific and convenient means of resolving pending disputes through payments by check and creates evidence that the payee had acceded to the resolution.  
An additional observation is that payees/ obligees in certain environments often do exercise control over the methods of payments they will take from their customers, but achieving these understandings takes planning (as in specifying the manner of payment in a contract for services or goods) or patience.  
Finally, payees of checks often can avoid legal protections provided for payors and issuers by routing the checks as ACH transactions or otherwise. Thus, even a careful issuer/ obligor may not in fact receive the protections they thought they would have by choosing to make payments by checks.
- (2) Real-time payments have many benefits, but also may have negative consequences. The rapidity with which checks are now collected vastly shortens the opportunity of a check issuer to stop payment on a check if the payee has not performed or has not performed according to the underlying contract.  
Additionally, the opacity of payments processors and the number of data security breaches experienced by them in the past few years raises different issues than those that depositors have encountered in dealing directly with banks.  
The types of real-time payments that many payments innovators mention focus on relatively low-dollar transactions in which either the goods are used or consumed immediately or the goods are virtual goods. Once individuals have had the value of the exchange in low-dollar transactions, the ability of the merchant to secure recourse from the other party is small.  
High-dollar value transactions may require more protections. I do not offer suggestions today about the cut-off point between low- and high-dollar transactions for this purpose, but I think the prospects of different rules for different types of risks should be considered rather than focusing on fashioning rules only for speed.  
The recent media attention to the obstacles to nearer-time retail payments appears to include the banking industry itself. As the reserve banks and industry groups move closer to rules for real-or nearer-time payments the costs of the transition must be weighed against the potential loss of certain income opportunities from slower payments.
- (3) No comment.
- (4) A. I support a more inter-operable system of validation, both for the existence of the account and the payer's right to use it for this purpose and for the sufficiency of funds to complete the payment. The key is the maintenance of sufficient

security for such a system to prevent security breaches of this goldmine of information.

B. Assurance that the payment will not be returned or reversed strikes me as a more complex issue than as it is presented. For example, if a payment is returned because it has been replicated or its integrity has been compromised in terms of misdirection by accident or outage, theft by an intermediary, or change in the amount and or due date of the payment, then these are types of protection that users of payment systems will seek, and it seems unfair not to offer these types of protections to users. The need for clear rules is even greater for consumers and small businesses that may be less sophisticated and may base expectations for new products on their experiences with established products. Rules for certain reversals or recourse rules, as I suggested above, also may need to be provided. Additionally, there probably is a need to continue to differentiate real- or near-real-time payments methods for consumers (and possibly small businesses) from traditional inter-bank wire transfer systems including Fedwire and CHIPS, in this and other important ways.

C. Timely notification to payer and payee is very important. This is very likely to help speed up P2P sales of goods and even those between small businesses and individuals where larger dollar values are concerned. Timely notifications can alert watchful payers to misdirection of payments or improper amounts, and can prevent overdrafts and NSF prosecutions.

But, timely notification systems also rely on secure databases of customer information so that notices reach the account holder, and are not diverted by fraudsters to themselves. A recent event in India underscores both the importance of timely notification and the risks in certain new payments methods: According to BNA's December 9, 2013 online report, cybercriminals made five withdrawals from [an individual]'s account and then deposited the money in two accounts through electronic transfers: the first with the Royal Bank of Scotland in New Delhi using the Real Time Gross Settlement process and the other with Central Bank through the National Electronics Fund Transfer system. Normally, banks in India send a text to the customer's mobile phone number to alert him or her about the transaction, but, according to BNA, "the hackers changed [the account holder]'s contact number when they hacked into the KYC database, so he received no alerts. [The account holder] did not notice the transfer until a check he wrote was rejected for insufficient funds. By the time [the account holder] alerted the bank of the unauthorized transactions, the hackers had withdrawn 252,000 rupees (\$4,092)." BNA additionally reported that "the hacker's illegal access to the KYC database to change a mobile contact number for bank alerts is the "first of its kind in India."

Moreover, BNA reported the conclusion of one cybersecurity expert in India, that mobile telecommunications operators in India are not following strict security precautions in issuing and changing subscriber identity module (SIM) cards. In other cases "fraudsters have gone to the victim's mobile operator, presented false papers and authorization documents in order to change" the SIM card customer information so the hackers can directly pose as the customer and make

transactions.” But BNA reported, in this case, the fraudsters accessed the bank's database and themselves changed the customer's mobile number in the database.” This type of fraud is known in the United States, where several court decisions place the fault with the banks involved, and only one recent case puts the fault with the customer.

D. No comment.

E. Masked account details matter to many users and make systems such as PayPal's and other “escrow” payments arrangements attractive. As a consultant who sees forged, counterfeit, and fraudulent instruments/ payments transactions, I would urge that, in any such masked account system, the basic transactional details be preserved and capable of being made available to those including law enforcement authorities and bank regulators as well as aggrieved account holders who may need the details to vindicate their rights.

- (5) Cross-border payments have suffered from the deficiencies noted. I urge that experience under the new Regulation E remittance rule be studied to see what effects it has on costs and fee-and-timing transparency.
- (6) The content-specificity of mobile payments is one of the obstacles to their adoption by many individuals because the availability of much of the transactional data along the string of potential processors and providers from payer to payee creates opportunities for data mining and security breaches that are likely to exceed what is present in systems today. Accordingly, privacy issues and appropriate sequestration of transaction information need to be built into mobile payments by design. (I can also see a new for an obsolescence period to be built into the privacy design.) Thus, I agree with the observations made on page 7 of the paper that complexity and inter-connectedness can exacerbate confidentiality and security in payments.  
I also agree that consumers who select certain payment instruments for their digital wallets may experience more limited choices of payments than theoretically is available today, but I repeat my observation that even individuals who think they have chosen one payment method (such as checks) over another may not get the payment system or protections they thought they were getting.
- (7) If mobile payments providers can provide information to businesses' accounting departments that rival checks or wire transfers for invoicing and auditing purposes, businesses will adopt those systems. Until this type of back-up information can be provided, many auditors will instruct clients to use systems that do.
- (8) There is no question that insecurity about payment integrity and the absence of clear legal regimes, including provisions for recourse, inhibits adoption of new payments methods by consumers.

### III. Responses to Questions for the Public

Because of the length of some of the questions in the Consultation Paper, I omit the questions themselves and refer to them simply by the number assigned to them in the Consultation Paper:

Q1. The Consultation Paper does not address issues pertaining to non-dollar clearing and settlements or the use of alternative currencies. Do the Reserve Banks intend to play a role in facilitating the development of non-legal-tender methods of payment or in the clearing and settlement of payments denominated in government-sponsored fiat currencies other than dollars in the same set of rules as may arise for domestic dollar-denominated payments? Do jurisdictional considerations hinder developments of this type?

Q2. Please see my comment on Question 1.

Q3. Assuming a possible bifurcation of low- and high-dollar payments as I have suggested, I can see Reserve Banks operating either, but the Reserve Banks' role in higher-dollar payments may be more important and less likely to disrupt private providers. As leaders and catalysts, I would recommend the Reserve Banks:

- a. Explore offering account masking services because of the regard for and implicit trust in reserve banks that regular users of payment systems have, and
- b. Continue to serve as a catalyst for work among providers whose ability to meet to discuss innovations and certain collaborations may be chilled by antitrust principles.

Q4. Current technologies employed by PayPal demonstrate that industry groups can offer a suitable model for real- or near-real-time payments with the features outlined in this question with the possible exception of near, real-time availability to the payee. If validation of the identities of payer and payee can be added to the existing technology, many of the goals here can be accomplished without Reserve Bank participation.

However, PayPal transactions may not be as well-designed for higher-dollar transactions. Further, the time-sensitivity and cash-management preferences of participants in higher-dollar transactions may make participation by Reserve Banks necessary in the higher-dollar, even more time-sensitive segment of this payment sub-market.

Q5. With the possible exception of markets in which readily transportable paper currency works with relative safety, I am not persuaded that any country has or will soon have “ubiquitous participation” in any payment system and it has been some time since checks were in fact nearly ubiquitous. Debit cards of various kinds, issued by banks and non-banks, seem to be stepping up into this space. It is unclear how long it will take for

mobile payments to replace debit cards for individuals, and it seems that it will take longer for mobile to replace systems that businesses now use.

Is ubiquity a necessary goal? Or, as we have now, are some payment forms likely to remain the provinces of individuals and businesses with vastly different needs for speed, cross-border delivery, and other special services? In other words, might we see a role for many kinds of products suited to specific domestic and cross-border purposes?

To the list of important features, I would add greater protection of the underlying transaction data from intermediaries in the payments processing tracks whose need to know about the transaction is less important than the movements of funds. I have the wholesale funds transfer system in mind, or at least the way in which its fixed fields used to limit the amount of transaction information that could “travel along” with the information moving from bank to bank as the payment instruction proceeded towards the bank representing the beneficiary of the payment. One reason I mention this is my impression, and it is only that, that there are no obvious barriers now to the multiplication of parties handling certain forms of payments – and mobile payments seem particularly at risk for this problem – primarily for the purpose of extracting transactional data from the payments data stream.

Q6. I have to state a bias that near-real-time payments may not be suitable for all purposes and certainly not for all domestic or cross-border payments. Near-real-time payments with satisfactory reversal and error-resolution rules are more attractive, because they reduce the opportunities for fraud that near-real-time payments seem to invite.

The question provided five options. Of these, I prefer options b, c, and d. Option b presents a greater opportunity for reserve banks to serve as catalysts and innovators. Option e would require both domestic and international cooperation. I predict higher transition costs in both economic and legal terms, and a longer likely wait for sufficient penetration to make the new system viable on its own. Option a has the advantage for the reserve banks and for banks with direct access to the current clearing and settlement systems of maintaining a central role for reserve banks and banks generally in the new system. Option a suffers, it would seem, from the same access issues for non-depository providers and for individuals who do not have and are not likely to have depository accounts.

Looking at subpart iii of this question, near-real time authorization and confirmation of available good funds strikes me as one of the most useful attributes of a new system, and goals that may be achievable with less expenditure than other options.

However, in subparts iii and iv, near-real time payments present significant obstacles to the achievement of certain United States anti-money laundering and economic sanctions goals. This may make the goal for domestic purposes more readily realized than for cross-border purposes. Additionally, demonstrated by recent efforts in New York, Maryland, and California and by the OCC and FDIC that address payments systems assistance to providers who lack licenses to operate in certain states or to provide

certain products in those states not all payments should be processed. Near-real time payments clearing and settlement in these cases could increase problems associated with illegal transactions or those that otherwise exceed the authority granted by the payer of the funds.

Q7. Until suitable legal protections cover issues such as accord and satisfaction, I would favor improving the check system over more attention to near-real time payments. This makes me sound more old-fashioned, but the cost of not having adequate legal regimes in place – for near-real time and for sped-up electrified transactions – is an externality that most individuals and small businesses cannot appreciate or handle. A failure to provide for these legal issues and others arising from a spate of fraud, like counterfeit “cashiers’ checks” and “money orders” circulating for fake Craigslist and other deals, imposes costs outside the payment system that will deter efficient adoption of newer payment systems, not assist it.

Q8. I have already identified certain new-age fraud risks in response to other questions raised in the consultation paper. One additional risk deriving from near-real time payments, with front end authentication and confirmation of good funds, relates to the ability of a thief/unauthorized person to determine the amount of available funds or credit lines on which to draw based on requesting confirmations up-front for each fraudulent transaction they hoped to complete.

Q9. Near-real time payments could increase the penetration of mobile payments in the small business community. Increased penetration may be good for small business because consumers will be drawn to the convenience, but also may be a challenge for small businesses who may be more vulnerable than larger businesses because smaller businesses may have to use higher cost payment systems to stay competitive in their community, and may have to bear the costs of transactions gone bad, all while operating on what may be a slim profit margin.

Q10. No comment.

Q11. No comment.

Q12. Direct linking of non-depository service providers to a database of this type is likely to increase fraud risks, given the issues identified by the states (described elsewhere in this comment letter) and, over a longer continuum, by the states and Federal Trade Commission and Department of Justice relating to payment processors representing domestic and offshore telemarketers. I would direct the Reserve Banks’ attention to the July 2013 notice of proposed rulemaking from the Federal Trade Commission that, among other things, would bar the use of certain payment products under the Telemarketing Sales Rule.

What bona fides would those eligible to access this new database be required to show? Would they be bonded or required to indemnify others in the payments stream for problems their participation might cause? Would the Reserve Banks potentially be willing to offer this service? At what price? With what types of warranties, representations, and indemnification requirements?

The easy solution to the creation, maintenance, and protection of such a clearinghouse of information is to have the Reserve Banks become this clearinghouse because of the implicit trust users of existing payments systems place in the Reserve Banks and the Federal Reserve System and because of their existing connectivity to major payments providers.

Q13. I see no reason to speed up migration in any artificial manner. Moreover, I note, based on the May, 2011, meeting convened by the Uniform Law Commissioners and some Reserve Bank representatives, the greatest opposition to speeding up some transactions, in particular by electrifying mortgage instruments, came from the America Bankers Association representatives.

Moreover, it would be a mistake to force migration from checks on any arbitrary schedule in my opinion. Checks serve many useful purposes, as the Paper notes. Moreover, until legal regimes emerge that offer pricing and protections for payments comparable to those found in checks – it is premature to force migration both for the Reserve Banks as trusted players and for end users.

Q14. No further comment.

Q15. No comment.

Q16. No further comment.

Q17. The cost of resolving disputes for individuals and small businesses, and the recent trend towards mandatory arbitration for dispute resolution, is a concern in any system that is more easily accessible by non-depositories and particularly for service providers not based in the United States, including tribes. Moreover, the cost of resolving disputes as well as the incentive to attempt to resolve them varies depending on whether the transaction is a high- or low-cost transaction. Many consumers have been forced to resort to class actions or class arbitration to justify the costs of resolving disputes arising from low-cost transactions.

Q18. No further comment.

Q19. No further comment.

Q20. Work by the Reserve Banks and others to encourage stronger security standards from end to end is vital to this progress.

#### IV. Conclusion

I urge the Reserve Banks to give more attention to solving issues that relate to domestic payments and their versatility and robustness, with particular attention to reasonable and transparent pricing for end users and workable, reasonably accessible and priced dispute and error resolution for consumers and small businesses.

Sincerely,

A handwritten signature in black ink, appearing to read "Sarah Jane Hughes".

Sarah Jane Hughes  
University Scholar and Fellow in Commercial Law