FEDERAL RESERVE SYSTEM

12 CFR Part 229

Regulation CC; Docket No. R-1409

RIN No. 7100-AD68

Availability of Funds and Collection of Checks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule, request for comment.

SUMMARY: On March 25, 2011, the Board published a notice of proposed rulemaking ("2011 proposal") intended to facilitate the banking industry's ongoing transition to fully electronic interbank check collection and return. Based on its analysis of the comments received in response to the 2011 proposal, the Board is revising its proposed amendments to subparts C and D of Regulation CC and is requesting comment on a revised proposed rule that would, among other things, encourage depositary banks to receive and paying banks to send returned checks electronically. The Board is requesting comment on two alternative frameworks for return requirements. Under Alternative 1, the expeditious-return requirement currently imposed on paying banks and returning banks for returned checks would be eliminated; a paying bank returning a check would be required to provide the depositary bank with a notice of nonpayment of the check—regardless of the amount of the check being returned—only if the paying bank sends the returned check in paper form. Under Alternative 2, the current expeditious-return requirement—using the current two-day test—would be retained for checks being returned to a depositary bank electronically via another bank, but the notice-of-nonpayment requirement

would be eliminated. The Board is proposing to retain, without change, the regulation's current same-day settlement rule for paper checks. In addition, the Board is also requesting comment on applying Regulation CC's existing check warranties to checks that are collected electronically and on new warranties and indemnities related to checks collected electronically and to electronically-created items.

DATES: Comments must be submitted by May 2, 2014.

ADDRESSES: You may submit comments, identified by Docket No. R-1409 and RIN No. 7100 AD 68, by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board's web site at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed

electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Sophia Allison, Senior Counsel (202/452-3565), Legal Division; or Tyler Standage, Financial Services Analyst (202/452-2087), Division of Reserve Bank Operations and Payment Systems; for users of Telecommunication Devices for the Deaf (TDD) only, contact 202/263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

A. Statutory and regulatory background

Regulation CC (12 CFR part 229) implements the Expedited Funds Availability Act of 1987 (EFA Act) and the Check Clearing for the 21st Century Act of 2003 (Check 21 Act).[1] The Board implemented the EFA Act in subparts A, B, and C of Regulation CC and the Check 21 Act primarily in subpart D.

The EFA Act was enacted to provide depositors of checks with prompt funds availability and to foster improvements in the check collection and return processes. Subpart A of Regulation CC contains general information, such as definitions of terms. Subpart B of Regulation CC implements the EFA Act's funds-availability provisions and specifies availability schedules within which banks must make funds available for withdrawal. Subpart B also implements the EFA Act's rules regarding exceptions to the schedules, disclosure of funds- availability policies, and payment of interest. As part of its 2011 proposal, the Board requested comment on proposed

[1] Expedited Funds Availability Act, 12 USC § 4001 *et seq.;* Check Clearing for the 21st Century Act, 12 USC § 5001 *et seq.*

amendments to subpart B. This notice of proposed rulemaking, however, does not address the proposed amendments to subpart B.[2] Because amendments to Subpart B must now be made jointly with the Consumer Financial Protection Bureau (CFPB), the Board does not propose amendment to Subpart B in this notice.

Subpart C of Regulation CC implements the EFA Act's provisions regarding forward collection and return of checks. Subpart C of Regulation CC includes provisions to speed the collection and return of checks, such as requirements for the expeditious return responsibilities of paying and returning banks, authorization to send returns directly to depositary banks, notification of nonpayment of large-dollar returned checks, standards for check indorsement, and specifications for same-day settlement of checks presented to the paying bank. The provisions of subpart C were adopted by the Board pursuant to §§ 609(b) and (c) of the EFA Act.[3] Section 609(b) directs the Board to consider requiring depository institutions and Federal Reserve Banks to take certain steps to improve the check-processing system, such as steps to automate the check-return process.[4] Section 609(c) authorizes the Board to regulate any aspect of the payment system and any related function of the payment system with respect to checks in order to carry out the provisions of the EFA Act.[5] In

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[2] Section 1086 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the EFA Act to make the Board's authority for the EFA Act's provisions implemented in Subpart B joint with the Consumer Financial Protection Bureau.

[3] EFA Act §§ 609(b) and (c); 12 USC §§ 4008 (b) and (c).

[4] EFA Act § 609(b)(4) states that "[i]n order to improve the check processing system, the Board shall consider (among other proposals) requiring, by regulation, that . . . the Federal Reserve banks and depository institutions take such actions as are necessary to automate the process of returning unpaid checks." 12 U.S.C. § 4008(b)(4).

[5] EFA Act § 609(c)(1) states that "[i]n order to carry out the provisions of this title, the Board of Governors of the Federal Reserve System shall have the responsibility to regulate—(A) any aspect of

addition, § 611(f) of the EFA Act authorizes the Board to impose on or allocate among depository institutions the risks of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks, and any related function of the payment system with respect to checks. Such liability may not exceed the amount of the check giving rise to the loss or liability, and, where there is bad faith, other damages, if any, suffered as a proximate consequence of any act or omission giving rise to the loss or liability.[6]

The current provisions of subpart C presume that banks generally handle checks in paper form. For example, the current expeditious-return provisions presume that banks are able to satisfy the expeditious-return requirement by using the same modes of transportation for paper returned checks that they used for forward collection of paper checks and that they can deliver returned paper checks at the same time that they deliver paper forward-collection checks.

B. Electronic check collection and return

The Check 21 Act, which became effective in October 2004, facilitated electronic collection and return of checks by permitting banks to create a paper "substitute check" from an electronic image of a paper check and from electronic information related to the paper check. The Check 21 Act authorized banks to provide substitute checks to a bank or a customer that had not agreed to electronic exchange. At the end of 2005, the Reserve Banks received about 4 percent of checks deposited for forward collection in electronic form and presented approximately 28

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the payment system, including the receipt, payment, collection, or clearing of checks; and (B) any related function of the payment system with respect to checks." 12 U.S.C. § 4008(c)(1).

[6] EFA Act § 611(f); 12 USC § 4010(f).

percent of their checks in electronic form.[7] Virtually all returned checks sent to and from Reserve Banks at that time were in paper form. Reserve Banks estimate that, by the end of 2013, more than 99.9 percent of all forward checks, 99.0 percent of FedReturn checks, and 97.0 percent of FedReciept Return checks will be processed in electronic form.

II. Overview of the 2013 Proposal

In 2011, the Board proposed amendments to subparts C and D of Regulation CC intended to facilitate the banking industry's ongoing transition to fully-electronic interbank check collection and return ("2011 proposal").[8] Based on its analysis of the comments received on the 2011 proposal, the Board has revised its proposed amendments to subparts C and D and is requesting comment on a revised proposed rule ("2013 proposal" or "current proposal"). Under the current proposal, As under the 2011 proposal, the Board proposes to exercise its authority under §§ 609(b) and (c) of the EFA Act to amend subparts C and D, and, in connection therewith, subpart A, of Regulation CC to provide incentives for depositary banks to receive, and paying banks to send, returned checks electronically.

This section describes the primary issues presented in the current proposal. A more detailed analysis of the proposed amendments is provided in the **Section-by-Section** analysis that follows this section. The Board requests comment on all aspects of the current proposal.

A. Return requirements

[7] Prior to the Check 21 Act, the Reserve Banks presented about 20 to 25 percent of their check volume electronically, primarily under MICR line presentment programs.

[8] 76 FR 16862 (Mar. 25, 2011).

The EFA Act, as implemented by subpart B of Regulation CC, establishes maximum time periods for the holds that depositary banks may place on funds deposited into checking accounts, including funds deposited by check, before making the deposited funds available to the customer. When the EFA Act was enacted in 1987, the time required for delivery of returned checks to the depositary bank was often longer than the maximum hold periods to which the banks would be subject under the EFA Act. At that time, checks typically were collected and returned in paper form, and returned checks were typically returned back through the path used for forward collection. Returning a check could take long periods of time if a paying bank were returning a check to a bank to which it was not sending checks for forward collection. In such situations, paying banks might not have the dedicated transportation infrastructure and in such cases would typically send the returned check by mail, which could significantly slow the return process.[9] To speed the return of checks and to reduce the risk that depositary banks would make funds from a check available before learning of the check's nonpayment, the Board exercised its authority under the EFA Act to eliminate the requirement that the check be returned through the forward endorsement chain and to adopt the expeditious return requirement in Regulation CC.[10]

Today, even more so than in 2011, checks are both collected and returned electronically. Electronic check-return methods substantially reduce risk to the check system because they result in returned checks being delivered to depositary banks

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[9] 52 FR 47112, 47118 (Dec. 11, 1987).

[10] 52 FR 47112, 47119 (Dec. 11, 1987).

more quickly and with fewer errors. In addition, electronic return methods are less costly than paper methods. The full benefits and cost savings of electronic check-return methods cannot be realized, however, if paying banks and returning banks must incur time and expense to deliver paper returned checks to depositary banks that have not agreed to electronic returns. Moreover, as technology has improved, the initial implementation and ongoing costs incurred by a depositary bank to receive and paying banks to send returned items electronically have decreased substantially.[11] Over time, these electronic delivery methods could become even faster and less expensive than they are today.

A check returned electronically can generally be delivered to a depositary bank within two business days of the check's presentment to the paying bank, even if the returned check is sent through more than one returning bank. Therefore, the barriers to faster return of checks that existed in 1988, when the expeditious-return requirement was first adopted, generally do not exist today, because checks need not be returned solely in paper form.

In addition, since the time when the expeditious-return requirement was first adopted, the forward collection of checks today is almost entirely electronic. A paying bank or returning bank that sends a paper returned check today typically must use the mail, because the dedicated air and ground transportation systems for paper checks have largely been discontinued. Therefore, if a paper check must be delivered

[11] For example, the Reserve Banks provide electronic copies of returned checks in .pdf files to small depositary banks, which can use the files to print substitute checks on their own premises if necessary. After printing the substitute checks, the depositary bank can process them in the same way it processes paper checks that are physically delivered to it.

to a depositary bank that does not accept returned checks electronically, or if the paying bank sends a paper returned check, the depositary bank is unlikely to receive the returned check within the expeditious-return deadline (i.e., by 4:00 p.m. on the second business day following presentment of the check to the paying bank).

1. Current rule

Under the current expeditious-return provisions of Regulation CC, a paying bank determines not to pay a check must return the check in an expeditious manner, as provided under either the "two-day test"[12] or the "forward-collection test".[13] To meet the two-day test, a paying bank must send a returned check in a manner such that the check would normally be received by the depositary bank not later than 4:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank. To meet the forward-collection test, a paying bank must send the returned check in a manner that a similarly situated bank would send a check (i) of similar amount as the returned check, (ii) drawn on the depositary bank, and (iii) deposited for forward collection in the similarly situated bank by noon on the banking day following the banking day on which the check was presented to the paying bank. Regulation CC also permits a paying bank to send a returned check either directly to the depositary bank or to any bank agreeing to handle the return expeditiously.[14]

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[12] 12 CFR 229.30(a)(1).

[13] 12 CFR 229.30(a)(2). 12 CFR 229.31(a) sets forth similar tests for returning banks for expeditious return of checks.

[14] 12 CFR 229.30(a).

In addition to requiring a paying bank to send a returned check expeditiously, Regulation CC currently requires a paying bank that determines not to pay a check in the amount of $2,500 or more to provide a notice of nonpayment to the depositary bank. The notice of nonpayment must be sent such that the notice is received by the depositary bank by 4:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank. Return of the check itself satisfies the notice of nonpayment requirement if the return meets the timeframe requirement for a notice of nonpayment.

2. 2011 proposal

By the end of 2010, the Reserve Banks received and sent virtually all forward-collection checks electronically. Although at that time the Reserve Banks received about 97.1 percent of returned checks electronically, they delivered only 76.7 percent of returned checks electronically. The 2011 proposal considered the Reserve Banks' check collection and return statistics to be representative of the industry-wide experience, and proposed amendments to subpart C to encourage depositary banks to accept returned checks electronically. The 2011 proposal would place the risk of non-expeditious return on a depositary bank that chooses not to accept electronic returns because of the prevalence of electronic check-return methods and the declining costs to a depositary bank to receive returned checks electronically.

Accordingly, the 2011 proposal proposed to revise the expeditious-return requirement in § 229.30 of Regulation CC to apply only to a depositary bank that

agreed to receive returned checks in electronic form from the paying bank.[15] Under the 2011 proposal, a depositary bank would be deemed to agree to receive a returned check in electronic form from the paying bank if the depositary bank agreed to receive an "electronic return" (i) directly from the paying bank; (ii) directly from a returning bank that holds itself out as willing to accept electronic returns directly or indirectly from the paying bank and has agreed to return checks expeditiously; or (iii) as otherwise agreed with the paying bank (e.g., through a network provided by a clearing house or other third party). Under the 2011 proposal, a paying bank would still be subject to Regulation CC's current midnight deadline provisions for all returned checks.[16]

The Board proposed in the 2011 proposal to retain the two-day test for expeditious return, and to delete the four-day test and the forward-collection test from Regulation CC. The Board also proposed in the 2011 proposal to eliminate the current notice-of-nonpayment requirement in Regulation CC[17] because the two-day timeframe for a notice of nonpayment would be the same as the proposed two-day timeframe for expeditious return in situations where the depositary bank has agreed to receive returned checks electronically. As a result, a depositary bank that did not agree to receive returned checks electronically from the paying bank under the 2011 proposal would not have been entitled to expeditious return of the check and also would not have been entitled to a notice of nonpayment. The Board specifically

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[15] The Board proposed to retain the two-day test for expeditious return, and to remove the four-day test and the forward-collection test. *See* Proposed § 229.30(a)(1) in the 2011 proposal, 76 FR 16862, 16895 (Mar. 25, 2011)).

[16] 12 CFR 22912 CFR 2290(c); see Uniform Commercial Code (UCC) § 4-302.

[17] 12 CFR 229.33(a).

requested comment in the 2011 proposal on whether the notice-of-nonpayment requirement should be retained for checks being returned to depositary banks that do not agree to accept electronic returns in a nearly all-electronic environment.

The Board also requested comment in the 2011 proposal on two alternative approaches to revising the expeditious-return requirement to encourage electronic returns. Under the first alternative, a bank that holds itself out as a returning bank would be required to accept a returned check electronically from any other bank that holds itself out as a returning bank (referred to in the 2011 proposal as the "ACH-operator-like" approach).[18] As noted in the 2011 proposal, this approach was intended to ensure that an electronic return could reach the depositary bank even if the paying bank and the depositary bank had electronic-return agreements with different returning banks. The 2011 proposal stated that this approach could be costly for returning banks to implement, because they would have to establish electronic return connections and agreements with every other returning bank. The second alternative would have required an electronic return to be returned through the forward-collection chain, essentially reverting to the pre-Regulation CC rule (referred to as the "Uniform-Commercial-Code (UCC)-like" approach). The 2011 proposal noted that some depositary banks might have agreements under which returned checks are delivered to a different location than that from which the depositary bank sends its checks for forward collection, and that the second alternative could interfere with the operation of those agreements. The Board also requested comment on

[18] This first approach was referred to as the "ACH-operator-like" approach because ACH network rules specify that an ACH operator must exchange files and entries with all other ACH operators. *See* Section 4.1.7 of the 2012 NACHA Operating Rules.

whether there might be other approaches preferable to those set forth in the 2011 proposal.

3. Summary of comments

a. Expeditious-return requirement

About 25 commenters specifically addressed the 2011 proposed amendments to eliminate the expeditious-return requirement. Almost all of these commenters broadly supported the proposal to eliminate the requirement for a paying bank or a returning bank if the depositary bank had not agreed to accept an electronic return directly or indirectly from the paying bank. A few commenters, however, opposed the elimination of the expeditious-return requirement, stating that eliminating a depositary bank's right to expeditious return if the depositary bank had not agreed to accept returns electronically would be too severe of a penalty. These commenters opposed using amendments to Regulation CC to encourage electronic check processing and stated that the marketplace should be allowed to determine how and when banks choose to accept returned checks electronically.

Almost all of the commenters that broadly supported eliminating the expeditious-return requirement, however, expressed concern with its practical implementation. In particular, commenters were concerned with two implementation challenges raised by the provisions in the 2011 proposal that would deem a depositary bank to have agreed to accept electronic returns from a paying bank if the depositary bank agrees to accept electronic returns directly from a returning bank that "has held itself out" as willing to accept electronic returns. First, some of these commenters believed that it would not always be practical for a paying bank to determine from

which returning bank the depositary bank has agreed to accept electronic returns. One commenter, however, stated that depositary banks that accept electronic returns from Federal Reserve Banks would not have to make such a determination.[19] Second, commenters were concerned that a paying bank might be subject to the expeditious-return requirement in circumstances where the paying bank did not have an *actual* electronic-return agreement in place with the returning bank that "has held itself out" as willing to accept electronic returns. These commenters stated that in such circumstances, it would be impractical for the paying bank both to establish a connection for electronic return to that returning bank and to return the check within the proposed two-day timeframe for expeditious return.

To address the second concern, one comment letter submitted by a group of institutions and trade associations ("group letter") proposed deeming a depositary bank to have agreed to receive electronic returns from the paying bank if the depositary bank has either (1) an agreement to receive electronic returns from a returning bank that, in turn, has an actual agreement in place with the paying bank to accept electronic returns, or (2) an agreement for expeditious return by means of an electronic return through the Federal Reserve Banks, regardless of whether the paying bank has an arrangement to send electronic returns through the Federal Reserve Banks. As an alternative to specifying that a depositary bank may agree to accept electronic returns from the Reserve Banks, the group letter suggested that a depositary bank could agree to accept electronic returns from a minimum percentage

[19] This commenter suggested that the Board designate the Reserve Banks' listing of the depositary-bank endpoints (routing numbers) to which they deliver returned checks electronically as the determinative source for paying banks to ascertain whether or not a depositary bank has agreed to accept electronic returns from Reserve Banks.

of all paying banks, or through a returning bank(s) that accepts electronic returns from a minimum percentage of all paying banks.[20]

The group letter acknowledged that the second alternative, in particular, could provide an incentive for depositary banks to accept returns electronically through the Reserve Banks, as opposed to other returning banks. The group letter stated, however, that the alternative recognized the nature of the paper and electronic check return system in which the Reserve Banks serve as the default returning bank for paying banks sending returned checks to depositary banks that the paying banks cannot reach electronically.

The Board also received comments on the ACH-operator-like approach and the UCC-like approach set forth in the 2011 proposal. All of these commenters opposed both alternatives. Commenters stated that the ACH-operator-like approach would be too costly, and with no certain benefit, because of the need to develop and implement operational integration between returning banks that does not exist today. Commenters also stated that the ACH-operator-like approach might undesirably lock the banking industry into using specific returning banks. In addition, commenters stated that the UCC-like approach likewise would be very disruptive to banks' existing check-collection processes, because not all banks that receive checks for collection in electronic form from depositary banks have comparable agreements in

[20] The group letter was signed by four groups representing depository institutions: The Electronic Check Clearing House Organization, The Clearing House, the Independent Community Bankers Association ("ICBA"), and the Technology Policy Division of the Financial Services Roundtable ("BITS"). Several other commenters stated that they supported the group letter, at least with respect to the suggested alternate approaches.

place to send returned checks in electronic form to the depositary banks from which they received presentment in electronic form.

b. Notice-of-nonpayment requirement

Approximately 20 commenters specifically addressed the provisions of the 2011 proposal regarding elimination of the notice-of-nonpayment requirement. About half of these comments supported the proposal and half opposed it. Commenters that supported the proposal stated that eliminating the requirement would encourage depositary banks to receive returns electronically and agreed that a depositary bank that receives electronic returns typically would receive the returns within the time in which it would otherwise receive the notice, thereby rendering a separate notice unnecessary. These commenters also stated that maintaining the notice-of-nonpayment requirement for checks being returned to depositary banks that do not agree to accept electronic returns would impose on paying banks the expense and operational burden of establishing processes to identify depositary banks that have not agreed to electronic return and of providing separate notices of nonpayment (i.e., in addition to the electronic return itself) to those banks.

In general, commenters opposing elimination of the notice-of-nonpayment requirement stated that the notice remains an important loss-prevention tool for depositary banks. Of the commenters opposed to the elimination, about half stated that depositary banks that have not agreed to receive returned checks electronically should continue to be entitled to receive a notice of nonpayment. Other commenters stated that even those institutions that receive electronic returns may receive the notice of nonpayment sooner than the electronic return, and that the faster receipt of

the notice can make a difference regarding the depositary bank's ability to charge back its customer's account before the funds are withdrawn.

4. 2013 proposal

The Board has considered the comments received on its 2011 proposal and is now requesting comment on two alternative approaches to the requirements imposed on paying banks and returning banks that return checks. These alternatives are intended to recognize that, in today's virtually all-electronic check processing environment, requiring expeditious return of paper checks imposes substantial cost on banks returning checks. The two alternatives also are intended to eliminate some of the concerns that commenters identified with the 2011 proposal.

a. The two alternatives in the 2013 proposal, described in greater detail below, are intended to identify the optimal incentives to impose on banks returning checks to encourage the broadest possible implementation of electronic check return. One alternative—Alternative 1—is intended to impose incentives on depositary banks to accept electronic returns by eliminating the expeditious-return requirement. Under this alternative, depositary banks that do not currently accept electronic returns would have a greater incentive to do so because only by receiving returns electronically would they be likely to learn about nonpayment of a deposited check within the current expeditious-return timeframes. The other alternative—Alternative 2—is intended to impose incentives on depositary banks to accept electronic returns by

generally retaining the expeditious-return requirement except where the depositary bank had not agreed to accept electronic returns. Under this alternative, depositary banks that do not currently receive electronic returns would have a greater incentive to do so because they would not otherwise be entitled to expeditious return of unpaid checks and would therefore be at a greater risk of having to make funds available to their customers before learning that the deposited check was returned unpaid.

Alternative 1—No Expeditious Return Requirement

Proposed Alternative 1 would eliminate the expeditious-return requirement imposed on paying banks and returning banks. Paying banks would continue to be subject to the UCC's midnight deadline for returning checks (including checks in electronic form), and returning banks would continue to be required to use ordinary care when returning the item.[21]

At the time that the Board initially adopted the expeditious-return requirement, the methods used for forward collection of checks were often were faster than those used to return checks.[22] The Board initially adopted the expeditious-return requirement in Regulation CC to speed the check-return process by encouraging paying banks to return checks to the depositary bank using the same

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[21] UCC § 4-302 provides that a payor bank is accountable for the amount of a check if the paying bank fails to return the item before its midnight deadline (i.e., by midnight of the banking day following the banking day on which the payor bank received the check). UCC § 4-202 states that a collecting bank exercises ordinary care "by taking proper action before its midnight deadline following receipt of an item, notice, or settlement. Taking proper action within a reasonably longer time may constitute ordinary care, but the bank has the burden of establishing timeliness."

[22] *See* 53 FR 19372 (May 27, 1988).

transportation methods as they used for forward collection. In today's virtually all-electronic check-processing environment, a check returned electronically should be received by the depositary bank as a practical matter within two business days of the check's presentment to the paying bank even without an expeditious-return requirement.[23]

Paper returned checks, however, are generally not delivered to depositary banks as quickly as checks returned electronically, and the UCC does not specify timeframes within which returned paper checks must be received by a depositary bank.[24] Therefore, Alternative 1 would require paying banks that return checks in paper form to provide notice of nonpayment to the depositary bank by 2:00 p.m. on the second business day following presentment of the check to the paying bank, regardless of the amount of the returned check.[25] The requirement for notice of nonpayment under Alternative 1 would not apply to a paying bank that sends the returned check electronically (either directly to the depositary bank or to a returning bank). The Board also proposes under Alternative 1 to move up the deadline for receipt of notice of nonpayment by the depositary bank from 4:00 p.m. to 2:00 p.m. (local time of the depositary bank) on the second business day following presentment of the check to the paying bank. The proposed 2:00 p.m. deadline would correspond

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[23] The time for receipt of the electronic return by the depositary bank could change if returning banks were to change their processing timeframes. It appears unlikely, however, that returning banks would change such processing timeframes given that their processes for electronic returns and there would not appear to be any benefit in changing them to allow for slower electronic processing.

[24] While the UCC imposes deadlines for when paying banks and returning banks must initiate returns, the UCC does not require returned checks to be received by depositary banks within a specified timeframe. *See* UCC § 4-202. Rather, UCC § 4-202 requires a returning bank to exercise ordinary care in returning checks to its transferor.

[25] Proposed 12 CFR 229.31(d).

to the earliest cutoff hour a bank may set under the UCC for items to be considered received on that banking day, rather than the next banking day.[26]

Alternative 1 is intended to create incentives for a depositary bank that still demands paper returns to transition to accept returns electronically, because the depositary bank still would be subject to the funds-availability timeframes in subpart B of Regulation CC even though it would not be entitled to expeditious return. Under Alternative 1, neither the paying bank nor the returning bank would be subject to an expeditious-return requirement or to a notice-of-nonpayment requirement if the paying bank sent the returned check electronically to a returning bank. This would be the case under Alternative 1 even if the returning bank had to create a substitute check to mail to the depositary bank. A depositary bank under Alternative 1 could reduce its risk of having to make funds available before learning whether a check has been returned unpaid by accepting returns electronically.

Alternative 1 also proposes, however, to impose a notice-of-nonpayment requirement on paying banks that choose to send a paper return. This provision of Alternative 1 is intended to impose on the paying bank the increased costs of providing notice of nonpayment to the depositary bank within the same amount of time that it would take for a check returned electronically to reach the depositary bank. Imposing this requirement on paying banks that send paper returns, regardless of the amount of the returned paper check, is intended to provide paying banks with an incentive to return checks electronically in order to avoid the costs and burdens associated with providing the notice of nonpayment.

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[26] UCC § 4-108.

The Board requests comment on whether eliminating the expeditious-return requirement might result in a slower check-return process, albeit one that is still electronic. The return process could be slowed, for example, if returning banks adjust return-processing timeframes or if multiple returning banks are involved in the return. The Board also requests comment on whether Alternative 1 should eliminate the notice-of-nonpayment requirement in addition to eliminating the expeditious return requirement. Commenters on the 2011 proposal stated that, in some cases, a paying bank with the capability to send returns electronically nonetheless must send a paper return.[27] In these cases, a paying bank would be unable to choose to send a returned check electronically in order to avoid the cost of sending notices of nonpayment. The Board requests comment on whether there continue to be circumstances under which a paying bank cannot avoid sending a returned check in paper form. The Board also requests comment on whether Alternative 1 should retain the notice-of-nonpayment requirement only for paper returned checks in amounts greater than $2,500. Retaining the $2,500 threshold for notice of nonpayment in such cases should reduce the number of notices that the paying bank would have to send, because the vast majority of checks are less than $2,500. The Board also requests comment on whether the threshold for notices of nonpayment should be increased to an amount above $2,500, such as $5,000.

[27] The group letter stated that electronically-enabled paying banks must send paper returns in some cases, citing as an example a check that does not qualify for handling as an image return under an electronic-return agreement, through no fault of the paying bank.

b. Alternative 2—Expeditious Return Requirement

Proposed Alternative 2 would preserve a requirement that a returned check reach the depositary bank within a specified timeframe similar to that proposed in the 2011 proposal. Specifically, § 229.31(b) in Alternative 2 would require a paying bank that determines not to pay a check return the check in a manner such that the returned check would normally be received by the depositary bank by 2:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank.[28] As under Alternative 1, the Board proposes under Alternative 2 to eliminate the forward-collection test and the four-day test and to retain only the two-day test for expeditious return.

A paying bank would not be subject to the expeditious-return requirement under Alternative 2 if the paying bank did not have an agreement to send electronic returns (1) directly to the depositary bank or (2) to a returning bank that is subject to the expeditious return requirement. Returning banks under Alternative 2 would be subject to a similar duty of expeditious return unless the returning bank did not have an agreement to send electronic returned checks to the depositary bank or to another returning bank that has an agreement to send electronic returned checks to the depositary bank, and the returning bank had not otherwise agreed to handle the returned check expeditiously.[29] Thus, similar to Alternative 1 and to the 2011

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[28] Section 229.31(b)(2) in Alternative 2 would provide that, if the depositary bank is closed on the second business day following presentment to the paying bank, the paying bank must return the check in a manner such that it would normally be received on or before the depositary bank's next banking day.

[29] As discussed in more detail in the **Section-by-Section** analysis, a returning bank would not be subject to the expeditious-return requirement under Alternative 2 if the returned check is deposited into a bank that is not subject to subpart B of Regulation CC or if the depositary bank is unidentifiable.

proposal, neither a paying bank nor a returning bank would have a duty of expeditious return under Alternative 2 if the depositary bank had not agreed to accept electronic returned checks from any returning bank.

Alternative 2 recognizes that in some cases a paying bank and a depositary bank use different returning banks, and that in these cases the returning bank from which the depositary bank has agreed to accept electronic returned checks may have an agreement to receive electronic returned checks from the paying bank's returning bank. Under Alternative 2, the paying bank and the paying bank's returning bank would be subject to the expeditious-return requirement in those cases.[30] Alternative 2 assumes that an electronic returned check that must be returned through multiple returning banks would still be delivered to a depositary bank within the proposed deadline for expeditious return. The Board requests comment on the extent to which an electronic returned check that must be processed by two returning banks would be unable to be delivered to a depositary bank within the proposed deadline.

Many commenters on the 2011 proposal supported the concept of applying the expeditious-return requirement only to returned checks destined for a depositary bank that has agreed to accept electronic returned checks. Most of these commenters, however, opposed the proposed circumstances under which a depositary bank would be deemed to have agreed to accept an electronic return from a paying bank such that the paying bank would be subject to the expeditious-return requirement. For example, many commenters expressed concern that a paying bank would be subject

[30] *See* proposed 12 CFR 229.31(b) and proposed 12 CFR 229.32(b).

to the expeditious-return requirement even though the paying bank did not have the necessary agreements or connections for electronic return at the time it would be required to send the return. Under such a situation, a paying bank would have to send a paper returned check in an expeditious manner, which would be very costly. Commenters also expressed concern that paying banks would be unable to determine from which returning bank(s) a depositary bank had agreed to accept electronic returns.

Alternative 2 is intended to address these concerns by generally not imposing an expeditious-return requirement on a paying bank if a returning bank with which the paying bank has an electronic return agreement does not, in turn, have an agreement to send electronic returned checks either directly or indirectly to the depositary bank. Moreover, Alternative 2 would not require a paying bank to determine from which returning bank(s) a depositary bank accepts electronic returns out of the universe of banks. Rather, a paying bank need only determine whether one of its returning banks also has an agreement to send returned checks electronically to the depositary bank.[31]

Many commenters on the 2011 proposal expressed concern with the proposed definition of "electronic return." These commenters stated that the proposed definition would lead to uncertainty as to which items were subject to the expeditious-return requirement. For example, commenters expressed concern that items would be subject to the expeditious-return requirement only if the item

[31] A paying bank could identify the depositary banks to which a returning bank sends returned checks electronically by, for example, a list of such banks published by the paying bank's returning bank.

complied with the specified industry standard, but not if the paying bank and returning bank had agreed to exchange electronic items in a different format. In the current proposal, the Board is proposing a new term, "electronic returned check," that is not limited to those items that comply with a particular industry format or to items a depositary bank has directly or indirectly agreed to receive from the paying bank. These provisions of the current proposal are intended to address commenters' concerns about varying the application of the expeditious-return requirement based on format or based on whether a depositary bank had agreed to accept the item.

Alternative 2 generally would impose an expeditious-return requirement on paying and returning banks only if the depositary bank has agreed to accept electronic returned checks directly from the paying bank (or returning bank) or from another returning bank with which the paying bank (or returning bank) has an electronic-return agreement. Alternative 2 proposes to eliminate the notice-of-nonpayment requirement for all returned checks. Alternative 2 presumes that the requirement would be redundant in light of the proposed two-day expeditious-return requirement. Alternative 2 is intended to provide depositary banks that accept only paper returns an incentive to accept returns electronically in order to obtain information more quickly about the nonpayment of a returned check. Alternative 2 is also intended to provide a depositary bank with an incentive to agree to accept electronic returned checks from a returning bank that agrees to receive electronic returned checks from a substantial number of paying banks and returning banks. This provision of Alternative 2 is intended to mitigate the likelihood that a depositary bank's returning bank would be able to charge other returning banks or paying banks high check-return fees because

the returning bank is the only connection to the depositary bank for electronic returned checks.[32] On the other hand, it could be argued that Alternative 2 provides paying banks with an incentive to enter into agreements to send electronic returned checks to returning banks that, in turn, have agreements with very few depositary banks or other returning banks. The Board requests comment on whether Alternative 2 provides the correct incentives for the efficient return of checks.

The Board recognizes that, in rare cases, a paying bank might not have any agreements to send electronic returned checks.[33] In these cases, a paying bank would not be subject to the expeditious return requirement under Alternative 2. The Board requests comment on the extent to which there are paying banks that do not have any agreements to send electronic returned checks. The Board also requests comment on whether Alternative 2 should retain the notice-of-nonpayment requirement in some form, for example, for those situations where the paying bank sends a paper returned check.

c. Other approaches to return requirements

The Board invites comment on whether the approaches suggested in the group letter would be preferable to either Alternative 1 or Alternative 2. One approach suggested in the group letter would entitle a depositary bank to expeditious return if it agreed to accept returns electronically from Reserve Banks. This approach could

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[32] If a depositary bank chooses to select electronic returned checks only from a single returning bank with few connections to other banks, it will be unlikely that the paying bank or the paying bank's returning bank has an agreement to send electronic returned checks to the returning bank selected by the depositary bank.

[33] The group letter stated that electronically-enabled paying banks must send paper returns in some cases, citing as an example a check that does not qualify for handling as an image return under an electronic-return agreement, through no fault of the paying bank.

effectively require banks to route returned checks only to specific returning banks. The other approach suggested in the group letter would entitle a depositary bank to expeditious return if it agreed to accept returns electronically from a minimum percentage of paying banks, or from a returning bank that accepted electronic returns from a minimum percentage of paying banks. If the minimum percentage were too high (the group letter suggested 75 percent as an example) under this approach, then accepting returns electronically through the Reserve Banks could be the only means for a depositary bank to meet the threshold. Under those circumstances, this approach could result in undue regulatory preference for the Reserve Banks' check-return services. Conversely, if the percentage were too low, the suggested approach could still result in a depositary bank accepting electronic returns from a returning bank with which the paying bank does not have an agreement for sending electronic returns.

B. Same-day settlement rule

1. Current rule

Section 229.36(f) of Regulation CC currently requires a paying bank to provide same-day settlement for checks presented in accordance with reasonable delivery requirements established by the paying bank and presented at a location designated by the paying bank by 8 a.m. (local time of the paying bank) on a business day. A paying bank may not charge presentment fees for checks – for example, by settling for less than the full amount of the checks – that are presented in accordance

with same-day settlement requirements.[34] The same-day settlement rule was established in 1994 to reduce the competitive disparity between the Reserve Banks and other presenting banks, and to balance the bargaining power between presenting banks and paying banks more equitably. Today's check-presentment environment is virtually all-electronic, and electronic check presentment is governed by agreements between the banks involved. As a result, it may no longer be necessary to set forth in Regulation CC the terms of presentment for the limited number of checks that continue to be presented in paper. The same-day settlement rule's proscription against paying banks' assessment of presentment fees, however, may continue to help balance the bargaining power between collecting banks and paying banks in entering into electronic-presentment agreements. If, in the future, the Board proposes to eliminate the same-day settlement rule, it could also propose to retain this proscription in order to maintain the current balance of bargaining power, as well as reduce the competitive disparities between Reserve Banks and private-sector banks.

2011 proposal

Under the 2011 proposal, a paying bank would have been permitted to require checks presented for same-day settlement to be presented electronically as "electronic collection items," provided the paying bank had agreed to receive electronic collection items from the presenting bank.[35] A paying bank would have been deemed to have agreed to receive an electronic collection item if it agreed to do so either

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[34] *See* paragraph (3)(a) of the commentary to § 229.36(f).

[35] Proposed § 229.2(s) defined an "electronic collection item" as an electronic image of and information related to a check that a paying bank sends for forward collection that (1) a paying bank has agreed to receive under proposed § 229.32(a), (2) is sufficient to create a substitute check, and (3) conforms with applicable industry standards for electronic images of and information related to checks. 76 FR 16862, 16887 (Mar. 25, 2011).

directly from the presenting bank or as otherwise agreed with the presenting bank. The timeframes, deadlines, and settlement methods for same-day settlement presentments of electronic collections items under the 2011 proposal would have been the same as those currently in effect for same-day settlement presentments of paper items.

2. Summary of comments

About 25 commenters addressed the provisions of the 2011 proposal on same-day settlement. The majority of these commenters found the proposal to be unclear, particularly regarding how, and from which banks, a paying bank must agree to receive presentment electronically in order to require same-day settlement presentment to be electronic. These commenters requested that the Board issue a revised proposal for electronic same-day settlement after reviewing the comments received on the 2011 proposal.

A minority of the commenters on the proposed same-day-settlement provisions of the 2011 proposal supported the proposal, stating that most small banks have adopted image-based check-processing technology and are no longer able to receive paper check presentments in large volumes and process them in an automated fashion. One commenter stated that banks' existing agreements for electronic presentment provide a reasonable framework for the electronic same-day settlement presentment contemplated by the Board's proposal. Another commenter supporting the 2011 proposal stated that the Board also should consider establishing a sunset date for paper presentments for same-day settlement because the value of accelerated

presentment and settlement is relatively lower today due to the increased efficiency of direct check-image exchange arrangements.

Several commenters stated that any rule governing electronic same-day settlement should preserve the ability of a presenting bank to receive same-day settlement for the checks without being charged fees by the paying bank (either presentment fees or fees for sending electronic collection items), as is the case for checks presented in paper form under the current same-day settlement rule. These commenters expressed concern that paying banks and presenting banks might be unable to reach an agreement as to the terms of electronic same-day settlement, or that paying banks would only enter into agreements where the designated electronic presentment point charged fees to the presenting bank. Some commenters stated that banks should continue to have the option to present paper checks for same-day settlement under the existing terms in the event that banks were unable to reach agreement on electronic presentment terms, even if the paying bank had already designated an electronic presentment point or had agreed to receive presentment electronically from another presenting bank.[36]

3. 2013 proposal

The Board proposes to retain, without change, the regulation's current same-day settlement rule. The 2011 proposal to incorporate electronic same-day settlement provisions into Regulation CC was intended to address the preference of many paying banks to receive all of their interbank check presentments electronically. At the time

[36] Several commenters also expressed concern with the definition of "electronic presentment point" (and the related definition of "electronic return point") used in the proposed definition of "electronic collection item." The revised proposal would not define the terms "electronic presentment point" and "electronic return point" and therefore does not address these comments in detail.

of the 2011 proposal, some presenting banks continued to present paper checks for same-day settlement under Regulation CC. Almost all checks are now presented electronically, however, and paying banks' prior concerns about paper-check presentments appear to have been ameliorated. The Board no longer believes it is necessary or appropriate to specify terms for electronic same-day settlement in Regulation CC because banks currently use electronic check presentment on a nearly universal basis. Instead, the terms of electronic presentment can be determined by banks' agreements, as they are under current industry practice. This approach is consistent with the approach taken elsewhere in the current proposal, under which a bank's acceptance of a check or returned check in electronic form is governed by the receiving bank's agreement with the sending bank (discussed below).

The Board requests comment on whether paying banks are continuing to receive paper checks presented for same-day settlement, and in particular requests comment on whether presenting banks that generally use electronic check-collection methods still present checks in paper form to a paying bank that has already established the capability to receive check presentments electronically. The Board also requests comment on whether it should apply the same-day settlement rule to electronic checks and, if so, how it might address the concerns of the commenters raised in connection with the 2011 proposal.

C. Framework for electronic checks and electronic returned checks

1. Current rule

Regulation CC applies to paper checks.[37] Therefore, subpart C's provisions related to acceptance of returned checks, presentment, and warranties do not apply to electronic images of checks ("electronic images") or to electronic information related to checks ("electronic information"). Rather, the collection and return of checks in electronic form is governed by agreements between the banks. These agreements may be bilateral, or in the form of a Reserve Bank operating circular or a clearinghouse agreement. The agreements often include, among other terms, warranties for electronic checks similar to those made for substitute checks under the Check 21 Act ("Check-21-like warranties"); that is, warranties that a bank will not be asked to pay an item twice and that the electronic image and electronic information are sufficient to create a substitute check.[38]

2. 2011 proposal

The Board's 2011 proposal would have added provisions that, in combination, created a default framework governing the collection and return of electronic images and electronic information.

a. Checks under subpart C

In addition to applying the expeditious-return requirement and same-day-settlement provisions of Regulation CC to electronic items, the 2011 proposal would have applied the other provisions of subpart C to electronic images and electronic information that a depositary bank agreed to receive from a paying

[37] Current § 229.2(k) generally follows the definition of "check" from the EFA Act, and does not include an electronic image of a check or electronic information related to a check within the definition of "check."

[38] With respect to checks and returned checks handled by the Reserve Banks, Regulation J (12 CFR part 210) provides similar protections to banks receiving electronic items from a prior bank. Clearinghouse rules also typically include such protection.

bank ("electronic return") and that a paying bank agreed to receive from a presenting bank ("electronic collection item"). Under the 2011 proposal, an item would be an "electronic collection item" or an "electronic return" only if (1) the item contained both an electronic image of a check and electronic information related to a check (or returned check), (2) the electronic image and electronic information were sufficient to create a substitute check, (3) the electronic image and electronic information conformed in format to American National Standard Specifications for Electronic Exchange of Check and Image Data—X9.100-187, in conjunction with its Universal Companion Document (hereinafter collectively referred to as ANS X9.100-187), unless the parties otherwise agree or the Board otherwise determines, and (4) the depositary bank or paying bank agreed to accept the electronic image and electronic information. The 2011 proposal would have specified under what circumstances a paying bank or depositary bank would be deemed to have agreed to receive electronic collection items and electronic returns and when they would be deemed to have been received.

b. Warranties

In the 2011 proposal, the Board proposed that § 229.34's existing warranties would be made by banks sending and receiving electronic collection items and electronic returns. In addition, the Board proposed new warranties that would apply specifically to electronic collection items and electronic returns. First, the Board proposed new Check-21-like warranties that would be made by a bank that transfers or presents an electronic collection item or an electronic return and receives consideration. In brief, the sending bank would warrant that the electronic image

accurately represents all of the information from the original check, that the electronic information contains an accurate record of all the MICR line information required for a substitute check, and that no person will be charged twice for the same item.

c. Electronically-created items

The 2011 proposal also contained provisions for warranties specifically related to "electronically-created items." Electronically-created items are electronic images that resemble images of the fronts and backs of paper checks but that were created electronically and not from, for example, scanning a paper check in order to create the electronic image. Electronically-created items are also sometimes referred to as "electronic payment orders" or "EPOs." For example, a corporate customer sending payments might, rather than printing and mailing a paper check, electronically create an image that looks exactly like an image of the corporate customer's paper checks, and e-mail the image to the payee. Alternatively, a consumer might use a smart-phone application through which the consumer is able to fill in the payee and amount, and provide a signature, on the phone's screen. The application then electronically sends the image to the payee.

Because these items never existed in paper form, they do not meet the definition of electronic images of checks or of electronic information related to checks and therefore they cannot be used to create substitute checks that are the legal equivalent of original paper checks. Nonetheless, electronically-created items are often sent through the check-collection system as if they are electronic images of paper checks.

The 2011 proposal would have provided a bank receiving an electronically-created item with certain warranty claims against a prior bank. Specifically, the Board proposed that a bank that transfers or presents an electronic image and related electronic information "as if" they were derived from a paper check would make the all warranties in current § 229.34, even if the electronic image and information were not derived from a paper check. For example, a bank sending an electronically-created item to another bank would be liable to that bank if that bank was asked to pay the item twice. The 2011 proposal also provided that the existing warranties applicable to paper remotely created checks (RCCs) would apply to electronically-created items that visually resemble RCCs.[39]

3. Summary of comments

a. Checks under subpart C

Three commenters, including the group letter, explicitly addressed the Board's proposal generally to apply the terms of subpart C to electronic collection items and electronic returns as if they were checks or returned checks. All three commenters generally supported this aspect of the 2011 proposal, because banks' agreements for the electronic collection and return of checks generally already treat images of and information related to checks as if they were checks or returned checks under Regulation CC, the UCC, and other applicable law. No commenter opposed applying subpart C of the regulation to these items as if they were checks.

[39] Section 229.2(fff) of the regulation defines "remotely created check" as a paper check that is not created by the paying bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn. Although the regulation's remotely created check warranty does not extend to the drawer, the drawer may be able to recover from the paying bank for an unauthorized remotely created check under UCC § 4-401.

Commenters, however, expressed numerous concerns with specific items that would be treated as checks under subpart C by virtue of the Board's proposed definitions of "electronic collection item" and "electronic return." At least one commenter believed that the Board's definitions were too limited in that they included only those images and information that a paying bank or depositary bank had agreed to receive directly or indirectly from certain banks, and not those items that, for example, a returning bank agreed to receive from a paying bank without the depositary bank, in turn, agreeing to receive the item from the returning bank. Commenters noted that the item sent between the paying bank and returning bank would not be an "electronic return" because the depositary bank would not have agreed to receive it from the paying bank under the 2011 proposal. These commenters stated that the proposal therefore created uncertainty as to the applicability of subpart C's provisions, because a bank might not know at the time it transfers an electronic image whether that image is an "electronic collection item" because the bank might not know whether the depositary bank or paying bank has agreed to receive the item electronically.

No commenter opposed, in concept, that an "electronic collection item" or "electronic return" be sufficient to create a substitute check. The group letter, however, suggested that banks may wish to agree to exchange electronic images and electronic information even though the images or information are insufficient to create substitute checks (for example, if the image is not readable by the machine that images checks). This letter suggested that the Board clarify that banks could agree to collect electronic images or electronic information that would otherwise be

insufficient to create a substitute check, and that the provisions of Regulation CC would not apply to those images or information.[40] Another commenter, however, opposed this suggestion, stating that it would result in a bifurcated system that would create even greater uncertainty.[41]

The Board received comments both supporting and opposing the provisions of the 2011 proposal that would specify the industry standard for "electronic collection items" and "electronic returns."[42] Some commenters stated that the regulation need not incorporate a standard, but should specify that banks handling electronic images must agree to a technical standard (for example, ANS X9.100-187), so long as the standard permits the receiving bank to create a substitute check.

b. Warranties

Eight commenters addressed the proposed Check-21-like warranties in the 2011 proposal. No commenter opposed, in concept, extending the existing warranties to electronic collection items and electronic returns, and four commenters explicitly supported it. Two commenters, including the group letter, wanted the Board to clarify that the parties may vary these warranties by agreement. Another commenter opposed varying the warranties by agreement, stating that it would create uncertainty.

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[40] To distinguish between electronic images and information that are "electronic collection items" and those that are not, some commenters suggested that clearinghouse rules could require items that are not "electronic collection items" to include a "flag."

[41] In some cases, typically those involving a small depositary bank, the depositary bank may not know how a subsequent correspondent bank or other collecting bank handles, or "flags," the item, and therefore may not know which warranties are applying to the item as it proceeds through the check-collection chain.

[42] Some commenters supported incorporating that standard, but thought that the phrase "as amended from time to time by ANS" should be added.

c. Electronically-created items

Eight commenters addressed the provisions of the 2011 proposal for applying existing warranties in Regulation CC to electronically-created items. Six commenters, including the group letter, explicitly supported the proposal. Three commenters, again including the group letter, requested that the Board clarify that the parties may vary the warranties by agreement. Another commenter opposed varying the warranties by agreement. One Reserve Bank commenter suggested that the Board expand its proposal to require a bank that introduces an electronically-created item into the check collection system indemnify all subsequent persons handling the electronically-created item against any loss or damage resulting from the fact that the electronically-created item was not captured from a paper check.

Eighteen commenters addressed the provisions of the 2011 proposal relating to "eRCCs" (electronically-created items that visually resemble RCCs).[43] Six commenters explicitly supported and no commenters opposed applying existing RCC warranties to eRCCs. The group letter recommended that the Board clarify that eRCCs would be subject to the RCC warranty. Most commenters that addressed eRCCs suggested that the Board apply all of subpart C's provisions to eRCCs.[44] Two

[43] An "eRCC" is an electronically-created item that does not bear the drawer's signature, that resembles an image of a remotely created check, and that would meet the regulation's definition of "remotely created check" (*See* current § 229.2(fff)), but for the fact that the item never existed in paper form prior to the depositary bank receiving the item electronically.

[44] A few commenters suggested that the Board apply the provisions of subpart C to eRCCs by modifying the definition of either "original check" or "remotely created check" to include remotely created checks that never existed as paper.

commenters opposed that approach, believing that further study by the Board and the public are necessary to determine an appropriate regulatory framework for eRCCs.[45]

Commenters were split on whether subpart C's provisions should apply to an electronically-created item that is created by the paying bank's customer. These electronically-created items resemble images of checks drawn by the paying bank's customer, rather than remotely created checks. Four commenters, including the group letter and one Reserve Bank commenter, stated that items created by a paying bank's customer are a potentially useful payment innovation, that their development has been impeded by uncertainty about the applicable legal framework, and that coverage under subpart C would be an enabling first step in the development of new products. Three commenters stated that it was too soon to determine whether these products should be treated as "checks" or whether they should be treated as a different type of payment instrument.

4. 2013 proposal

The Board is proposing a revised regulatory framework for the collection and return of checks in electronic form based on its analysis of the comments received on the 2011 proposal. Under the 2013 proposal, electronic images and electronic information will be treated as checks under subpart C (with proposed simplifications to the applicable definitions). The 2013 proposal would apply Check-21-like warranties to electronic images and electronic information. The 2013 proposal would

[45] A few commenters indicated that eRCCs are in limited use within the check-collection system. For example, telemarketers, on-line businesses, or other payees that would normally use remotely created checks use eRCCs instead to avoid the cost of printing and then truncating the remotely created check. Some commenters questioned whether there are legitimate reasons for merchants or billers to use eRCCs, as opposed to using ACH debits.

also require a bank sending an electronically-created item to indemnify subsequent transferees for losses caused by the fact the item was not derived from a paper check.[46] The 2013 proposal also provides for a new indemnity relating to remote deposit capture services. The proposed new indemnity would cover depositary banks that receive deposit of an original paper check that is returned unpaid because it was previously deposited (and paid) using a remote deposit capture service.

a. Checks under subpart C

Under proposed § 229.30(a) of the 2013 proposal, electronic images of checks and electronic information related to checks that banks send and receive by agreement would be subject to the provisions of subpart C as if they were checks, unless otherwise agreed by the sending and receiving banks. In general, the Board proposes to use the terms "electronic check" and "electronic returned check," set forth in proposed § 229.2(ggg), instead of "electronic collection item" and "electronic return" as in the 2011 proposal. An item would be an "electronic check" or an "electronic returned check" based on whether the sending bank and the receiving bank have an agreement to send the item electronically, and not based on whether a paying bank or depositary bank has agreed to receive the item electronically. A sending bank must have an agreement with the receiving bank in order to send an electronic check or electronic returned check. Like the 2011 proposal, the 2013 proposal would not require a bilateral agreement between the receiving bank and the sending bank; a

[46] The 2011 proposal would have applied the warranties set forth in current 229.34 to electronically-created items instead of providing for an indemnity.

Reserve Bank operating circular, clearinghouse rule, or other interbank agreement may serve as an "agreement" to send and receive items electronically.

The 2013 proposal would permit sending banks and receiving banks to agree to send and receive electronic images and electronic information that do not conform with ANS X9.100-187. Therefore, unlike the 2011 proposal, electronic checks and electronic returned checks could include electronic images of checks sent without accompanying electronic information and electronic information sent without an accompanying image.

Proposed § 229.30(a) would provide that electronic checks and electronic returned checks are subject to subpart C as if they were checks or returned checks, unless otherwise provided in that subpart. Specifically, other provisions of subpart C would specify that the parties' agreements govern the receipt of electronic checks and electronic returned checks,[47] and proposed § 229.34 would set forth warranties (discussed below) that would be given with respect to electronic checks and electronic returned checks. Pursuant to existing § 229.37 of subpart C, the parties could, by agreement, vary the effect of the provisions of subpart C as they apply to electronic checks and electronic returned checks.

b. Warranties

Proposed § 229.30(a) would apply the provisions of subpart C to electronic checks and electronic returned checks. Specifically, proposed § 229.30(a) would apply the existing paper-check warranties in § 229.34 to electronic checks and

[47] See proposed § 229.33(a) (depositary bank acceptance of electronic returned checks) and proposed § 229.36(a) (paying bank acceptance of electronic checks).

electronic returned checks (as in the 2011 proposal). These warranties would include the returned-check warranties[48] in proposed § 229.34(e), the warranty of notice of nonpayment in proposed § 229.34(f) of Alternative 1,[49] the warranty and associated offset provisions for settlement amount and encoding in proposed § 229.34(d),[50] and the transfer and presentment warranties related to a remotely created check in proposed § 229.34(c).[51]

The current proposal would provide for additional warranties relating to electronic checks and electronic returned checks. For example, proposed § 229.34(a) would set forth the Check-21-like warranties for electronic checks and electronic returned checks,[52] and proposed § 229.37(a) would permit a sending and receiving bank by agreement to vary the warranties the sending bank makes to the receiving bank for electronic checks and electronic returned checks.[53] As in the 2011 proposal, the Board proposes that these warranties flow, for electronic checks, to the drawer and, for electronic returned checks, to the owner, in addition to the banks receiving the items.

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[48] See current § 229.34(a).

[49] See current § 229.34(b).

[50] See current § 229.34(c).

[51] See current § 229.34(d).

[52] These warranties are substantively equivalent to those set forth in the 2011 proposal.

[53] Such an agreement could provide, for example, that the bank transferring the electronic check does not warrant that the electronic image or information are sufficient to create a substitute check. The agreement would not, however, vary the effect of the warranties with respect to banks and persons not bound by the agreement.

c. Electronically-created items

The Board is proposing to add indemnities related to electronically-created items, rather than to expand the § 229.34 warranties to those items, as in the 2011 proposal. Proposed § 229.34(b) would provide that a bank that transfers an electronic image or electronic information that is not derived from a paper check (i.e., an electronically-created item) indemnifies each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim, or damage that results from the fact that the image or information was not derived from a paper check. Proposed § 229.34(i) would limit the amount of the indemnity so that it would not exceed the amount of the loss of the indemnified bank, up to the amount of settlement or other consideration received by the indemnifying bank and interest and expenses of the indemnified bank (including costs and reasonable attorney's fees and other expenses of representation).

An electronically-created item cannot be used to create a substitute check that meets the legal equivalence requirements of the Check 21 Act and Regulation CC[54] because an electronically-created item is not derived from a paper check. As a practical matter, however, a bank (including perhaps the depositary bank) receiving an electronically-created item might be unable to distinguish the item from any other image of a check that it receives electronically. Accordingly, the bank unknowingly may transfer the image as if it were an electronic check or electronic returned check

[54] A substitute check is the legal equivalent of the original check only if the substitute check accurately represents all of the information on the front and back of the original check when the original check was truncated. Truncate, as defined in the Check 21 Act and Regulation CC, means removing an original *paper* check from the check collection or return process. In the case of an electronically-created item, there is no original check of which a substitute check can be a reproduction.

(i.e., as if it were derived from a paper check), or produce a paper item that is indistinguishable from a substitute check (although not a valid substitute check because it was not derived from a paper check). The indemnity in proposed § 229.34(b) would protect a bank that receives an electronically-created item, creates a substitute check from it, and incurs losses because the substitute check it created was not the legal equivalent of the original check.The Board is proposing an indemnity for harm caused by the fact that an electronically-created item was not derived from a paper check instead of applying the warranties of current § 229.34 to electronically-created items because the Board believes that these items do not fit well into the existing warranty framework of § 229.34.[55] Banks may still incur losses on these items, however, that they are unable to recover from the sending bank because check warranties do not apply.[56] Accordingly, proposed § 229.34(b) would provide a bank that is unable to make a warranty claim (i.e., because the image and information was not derived from a paper check) with an indemnity claim against a prior sending bank for losses caused from the fact that the item was not derived from a paper check.

The Board requests comment on its proposal to provide an indemnity claim related to electronically-created items instead of extending the check warranties of current § 229.34 to electronically-created items. The Board further requests comment

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[55] For example, it is not clear whether the midnight deadline provisions of the UCC apply to electronically-created items.

[56] In some cases, sending and receiving banks may have incorporated indemnities related to electronically-created items into their electronic check exchange agreement. In these cases, the receiving bank may be able to recover from the sending bank through a breach-of-contract claim.

on whether losses proximately caused from not being able to make the warranty claim should be interpreted to cover damages awarded for violations of Regulation E.

d. Indemnity related to remote deposit capture

Remote deposit capture is a practice where a bank permits its customer to make a deposit by sending an electronic image of the front and back of a check. Depositary banks typically set forth the terms of the remote deposit capture service in their agreements with their customers. Subpart C of Regulation CC does not explicitly address issues related to remote deposit capture, and the Board did not propose any related amendments as part of its 2011 proposal. In recent years, remote deposit capture has become more prevalent, particularly for consumer accounts.

Once a customer has used a depositary bank's remote deposit capture service to send an image of the front and bank of a check for deposit, the customer typically retains the original check for the time specified under the agreement with the depositary bank. The Board has become aware of situations where a deposit is made at one bank using a remote deposit capture service and the original check is deposited at another bank. In these situations, if the original check is deposited after the image deposited through a remote deposit capture service, the original check typically would be returned to the depositary bank unpaid because the paying bank has already paid the check.[57]

If the paying bank returns the original check to the depositary bank that accepted it for deposit, that depositary bank might be unable to charge the returned

[57] Alternatively, it is possible that the original check is deposited first, followed by subsequent remote deposit capture.

check back to its customer's account (for example, the customer may have already withdrawn the funds). It is not clear whether the depositary bank that accepts the original check would be able to identify or recover directly from a depositary bank that accepted and received settlement for a deposit made through a remote deposit capture service.

Accordingly, the Board proposes to add a new indemnity in § 229.34(g) related to remote deposit capture services. Proposed § 229.34(g) would cover situations where a depositary bank that is a truncating bank under § 229.2(eee)(2) (i.e., because its customer created an image of the front and back of the check and deposited it through a remote deposit capture service) accepts and receives settlement or other consideration for the check deposited through remote deposit capture, but does not receive the original check and does not receive a return of the check unpaid. Under these circumstances, proposed § 229.34(g) would indemnify another depositary bank that accepts the original check for deposit for that bank's losses due to the check having already been paid.[58] This indemnity would allow a depositary bank that accepts deposit of an original check to recover directly from a bank that permitted its customer to deposit the check through remote deposit capture.

The Board believes that the depositary bank that accepts an original paper check should not bear the loss if that check has been deposited multiple times. Rather, the depositary bank that introduced the risk of multiple deposits of the same

[58] A depositary bank is a truncating bank under § 229.2(eee)(2) if a person other than a bank truncates the original check, but the depositary bank is the first bank to transfer, present, or return, in lieu of the original check, a substitute check or, by agreement with the recipient, information relating to the original check (including data taken from the MICR line of the original check or an electronic image of the original check).

check by offering a remote deposit capture service should bear the losses associated with multiple deposits of a check. A depositary bank that receives the benefit of permitting its customers to use remote deposit capture should also internalize any risk or cost to other banks that may result from remote deposit capture. One such risk is that the customer will deposit the original check at another bank. That bank that accepted the check by remote deposit capture is in a better position than any other bank to minimize those costs and risks through the terms of its contract with its customer.

The Board requests comment on all aspects of this indemnity, including any unintended consequences that might result. The Board also requests comment on whether the depositary bank that accepts the original check for deposit would be able to identify the depositary banks against which it may bring a claim for indemnity (i.e., those banks that accepted the check through remote deposit capture from their customers) and whether there are other more efficient or practical remedies to address the underlying problem.

III. Section-by-Section Analysis

The paragraph citations in this section are to the paragraphs of the proposed rule unless otherwise stated. The Board requests comment on all aspects of the proposed rule.

D. Definitions

1. Section 229.2(dd) – Routing number

In the 2011 proposal, the Board proposed to revise the definition of the term "routing number" to include a bank-identification number contained in an electronic

image or electronic information. In the current proposal, the Board is proposing substantively identical revisions to the definition of "routing number" and to the related commentary.[59]

One commenter on the 2011 proposal stated that the proposed revisions to the commentary incorrectly stated that the number appearing in the electronic information related to a payable-through check was that of the "paying bank," as opposed to "payable-through bank." Accordingly, the Board is proposing revisions to the commentary to the definition of "routing number" to clarify that, in the case of payable-through checks, the routing number appearing on the check is that of the payable-through bank.

2. Section 229.2(vv) – MICR line

Regulation CC currently defines "MICR line" as the numbers printed near the bottom of a check in magnetic ink, in accordance with American National Standard Specifications for Placement and Location of MICR Printing, X9.13 (hereinafter ANS X9.13) for an original check and American National Standard Specifications for an Image Replacement Document – IRD, ANS X9.100-140 (hereinafter ANS X9.100-140) for a substitute check, unless the Board by rule or order determines that different standards apply.[60] The 2011 proposal did not propose any amendments to this definition. In the current proposal, the Board proposes to amend the definition of "MICR line" for purposes of subpart C and subpart D so that it includes the numbers

[59] Although the term "routing number" is used in subpart B, amendments to subpart B must be joint with the CFPB. Accordingly, the proposed amendments would apply only for purposes of subparts C and D.

[60] The commentary to the definition of "MICR line" currently provides that industry standards may vary the requirements for printing the MICR line, such as by indicating the circumstances under which the use of magnetic ink is not required.

contained in an electronic image or electronic information in accordance with American National Standard Specifications for Electronic Exchange of Check Image Data – Domestic, X9.100-187 (hereinafter ANS X9.100-187), unless the Board determines by rule or order that different standards apply.

The 2011 proposal proposed to add the new defined terms "electronic collection item" and "electronic return" to Regulation CC. In commenting on these provisions of the 2011 proposal, commenters recommended that the Board not specify a standard for electronic images and electronic information, in part because commenters stated that parties should have the flexibility to agree to exchange electronic images and electronic information that did not satisfy a specified standard. For example, banks may agree to different standards or practices, including that, for purposes of subpart C, the MICR line information may be in a format other than that required by ANS X9.100-187.

In the current proposal, the Board proposes to revise the commentary to the definition of "MICR line" to state that the banks exchanging electronic checks may agree to specify the applicable standard for electronic checks and electronic returned checks. The Board requests comment on whether the "MICR line" definition should specify an industry standard at all, given that the exchange of electronic items between banks is by agreement.

3. Section 229.2(bbb) – Copy and sufficient copy

The terms "copy" and "sufficient copy" were added to Regulation CC in 2004 in connection with the adoption of the final rule implementing the Check 21 Act.[61] The term "copy" is used throughout subpart C (for example, in connection with the notice in lieu of return provisions). The Board did not propose any revisions to the definitions of "copy" and "sufficient copy" as part of the 2011 proposal.

Currently, the definition of "copy" in Regulation CC is limited to paper reproductions of checks. In the current proposal, the Board is proposing to expand the definition of "copy" to include an electronic reproduction of a check that a recipient has agreed to receive from the sender instead of receiving a paper reproduction.

Regulation CC currently defines a "sufficient copy" as a copy of an original check that accurately represents all of the information from the front and back of the original check as of the time the original check was truncated or is otherwise sufficient to determine whether or not a claim (such as an indemnity claim or an expedited recredit claim) is valid. The current proposal does not contain any proposed revisions to the definition of "sufficient copy." The Board, however, is proposing to clarify in the commentary to the definition of "sufficient copy" that a "sufficient copy" must be a copy must be of the original check (and not of a substitute check).[62]

4. Section 229.2(ggg) – Electronic check and electronic returned check

The current definition of "check" (§ 229.2(k)) does not include electronic images and electronic information. In the 2011 proposal, the Board proposed to

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[61] 69 FR 47290, 47309 (Aug. 4, 2004).
[62] See proposed commentary to § 229.2(bbb) at paragraph 2.

define the new terms “electronic collection item” and “electronic return”. In the current proposal, the Board proposes to include two new defined terms, “electronic check” and “electronic returned check,” in Regulation CC. The current proposal would define “electronic check” and “electronic returned check” as (1) an electronic image of a check, or returned check, or electronic information related to a check, or returned check, that a bank sends to a receiving bank pursuant to an agreement with the receiving bank, and (2) that conforms with ANS X9.100-187, unless the Board determines that a different standard applies or the parties otherwise agree. The current proposal, unlike the 2011 proposal, would permit the sending and receiving banks to agree that an “electronic check” or an “electronic returned check” need not contain both an electronic image and electronic information. Under the current proposal, an “electronic check” or “electronic returned check” need not be sufficient to create substitute checks in order to meet the definitions. Under proposed § 229.34(a), however, parties sending and receiving electronic checks and electronic returned checks would warrant that such items are sufficient to create substitute checks, unless the parties otherwise agree.

The proposed commentary to the definition of “electronic check” and “electronic returned check would clarify that the terms of the agreements for sending and receiving electronic checks and returned checks may vary. For example, banks may agree that both an electronic image and electronic information for presentment, or they may agree that the electronic information alone is sufficient for presentment. Additionally, the agreements may differ as to what constitutes receipt of an electronic check or electronic returned check.

E. *Subpart C—Collection of Checks*

As noted above, the Board is proposing two alternative approaches to the requirements that apply to the return of checks. Generally speaking, the expeditious-return provisions that the Board proposes to delete in Alternative 1 would be retained (in some form) in Alternative 2. Likewise, the notice-of-nonpayment provisions that the Board proposes to retain in Alternative 1 would be deleted in Alternative 2.

1. Section 229.30 – Electronic images and electronic information

b. Section 229.30(a) – Checks under this subpart

The Board proposes a new § 229.30(a), which would provide that electronic checks and electronic returned checks are subject to the provisions of subpart C as if they were checks or returned checks, unless the subpart provides otherwise. Examples of where subpart C would provide otherwise include proposed §§ 229.33(a) and (b) and §§ 229.36(a) and (b), because these provisions differentiate between checks in electronic form and checks in paper form for purposes of where depositary banks and paying banks must receive checks. Another example is proposed § 229.37, which would permit the parties to vary by agreement the effect of the provisions of subpart C as they apply to electronic checks and electronic returned checks.

Some commenters on the 2011 proposal, such as the group letter, suggested that banks be allowed to agree to collect electronic check images or electronic check information that do not conform to ANS X9.100-187.[63] These commenters stated

[63] For example, banks may wish to exchange an electronic image of a check that is readable but insufficient to create a substitute check due to incomplete MICR line information.

that, in such cases, the provisions of Regulation CC should not apply to the exchanged images or information.

In the current proposal, however, the Board proposes in proposed § 229.30(a) to apply the provisions of subpart C to electronic check images and electronic check information notwithstanding the suggestions of commenters on the 2011 proposal. The Board believes that its proposed approach creates a uniform default framework for all electronic images and information that parties agree to exchange. As noted in the proposed commentary to § 229.30(a), § 229.37 permits banks to agree to vary the application of subpart C with respect to electronic checks. For example, as noted in paragraph A.3. of the proposed commentary to § 229.34(a), banks that exchange electronic checks may agree to vary the warranties in proposed § 239.34(a) to provide that the bank transferring the electronic image or electronic information does not warrant that the image or information is sufficient to create a substitute check.

e. Section 229.30(b) – Writings

The Board proposes a new § 229.30(b) that would permit certain writings to be provided in electronic form. Specifically, proposed § 229.30(b) would permit a bank to satisfy a writing requirement under subpart C by providing the information in electronic form if the receiving bank has agreed to receive that information electronically from the sending bank. For example, under proposed § 229.30(b), a bank could send a notice in lieu of return required by proposed § 339.31(f) electronically if the receiving bank agreed to receive the notice electronically.

2. <u>Section 229.31 – Paying bank's responsibility for return of checks and notices of nonpayment</u>

a. The provisions of proposed § 229.31 are the same under Alternative 1 and Alternative 2 unless otherwise indicated. Section 229.31(a) – Return of checks

Currently, § 229.30(a) sets forth a paying bank's expeditious return requirement. The undesignated paragraph in § 229.30(a) provides that a paying bank may send a returned check to the depositary bank or to any other bank agreeing to handle the returned check expeditiously. The undesignated paragraph also provides that a paying bank may create a qualified return check (and sets forth format standards for qualified returned checks) and provides that § 229.30(a) does not affect a paying bank's responsibility to return a check within the deadlines required by the UCC, Regulation J (12 CFR part 210), or § 229.30(c).

In proposed § 229.31(a), the Board proposes to retain the provisions currently set forth in the existing undesignated paragraph of § 229.30(a), subject to the revisions discussed below. Under Alternative 1, proposed § 229.31(a)(1) eliminates the expeditious return requirement imposed on a paying bank. Accordingly, in Alternative 1, the Board proposes to remove the provisions setting forth the two-day/four-day test and the forward-collection test, as well as remove all references to expeditious return from the rule text and the commentary. Under Alternative 2, proposed § 229.31(a)(1) retains a modified expeditious return requirement as set forth in proposed § 229.31(b), while proposed § 229.31(b) under Alternative 2 would provide for only a two-day test for expeditious return. Alternative 2, like proposed Alternative 1, would permit a paying bank that is returning a check to send the returned check directly to the depositary bank, to any other bank agreeing to handle

the returned check, or as provided in proposed § 229.31(a)(2) (unidentifiable depositary bank). In Alternative 2, however, a paying bank's choice of return path would be subject to the requirement for expeditious return. The Board is proposing to eliminate the restriction that a paying bank may send the returned check only to a returning bank that agrees to handle the return expeditiously (except in cases where the depositary bank is unidentifiable). The Board believes that this is redundant in light of the overall condition in proposed § 229.31(a)(1) (and current § 229.30(a)) that the choice of return path is subject to the expeditious-return requirement.

Proposed § 229.31(a)(1) under both Alternative 1 and Alternative 2 would permit a paying bank to send a returned check to the depositary bank, to any other bank agreeing to handle the returned check, or as provided in proposed § 229.31(a)(2) if the depositary bank is unidentifiable. Retaining these provisions in Regulation CC permits paying banks to continue to return checks using more direct paths to depositary banks than otherwise permitted under UCC § 4-301(d).

Proposed § 229.31(a)(2) would set forth the provisions of current § 229.30(b) that permit a paying bank to send a return check to any bank that handled the check for forward collection when the paying bank is unable to identify the depositary bank.[64] In 2011, the Board proposed to revise the commentary to this provision to provide that, for purposes of an electronic image and electronic information, a depositary bank is unidentifiable only if the depositary bank's indorsement is not in either an addenda record or in the image of the check. The depositary bank would not

[64] As with other provisions of the 2013 proposal, under Alternative 1, the Board would remove all references to the expeditious return requirement.

be unidentifiable, however, merely because the depositary bank's indorsement is not attached as an addenda record, such that the paying bank must retrieve and visually review the image. The group letter expressed support for this approach. The Board proposes to retain this approach in the proposed commentary to § 229.31(a)(2).

The 2011 proposal also proposed commentary on how a paying bank returning a check for which it cannot identify the depositary bank must advise the bank to which it is sending the check that it is unable to identify the depositary bank. Specifically, in the case of an electronic return, the Board proposed that the advice requirement may be satisfied by the paying bank inserting the routing number of the bank to which it is sending the return where the paying bank otherwise would have inserted the routing number of the depositary bank. Three commenters addressed this aspect of the 2011 proposal and stated that such an approach would cause confusion at returning banks that may also serve as depositary banks. These commenters suggested the Board continue to leave to industry standards and interbank agreements the matter of how to advise a receiving bank that the depositary bank is unidentifiable within an electronic return. The current proposal adopts the approach suggested by these commenters in the proposed commentary to proposed § 229.31(i) which provides that, in the case of an electronic returned check, the advice requirement may be satisfied in such a manner as the parties agree.

One Reserve Bank commenter suggested that the Board further revise this provision to preclude a bank that receives a returned check that it handled for forward collection and that is properly advised that the depositary bank is not identifiable from sending the returned check back to the returning bank or the paying bank or

from claiming that the item is "not our item" (NOI) through a process like the Reserve Banks' adjustment procedures. The Board requests comment on whether it should incorporate such a provision into the regulation.

In proposed § 229.31(a)(3), the Board proposes to retain the portions of the undesignated paragraph in current § 229.30(a) that permit paying banks to qualify returned checks and that instruct paying banks on how to do so. In the 2011 proposal, the Board requested comment on whether the regulation's provisions for qualifying of paper returned checks by paying banks and returning banks should be deleted. All four commenters responding to this aspect of the 2011 proposal, including the group letter, indicated that the need still exists for qualified returns and carrier envelopes, and that there would be costs associated with implementing alternative methods for returning checks which currently are prepared as qualified returns or use carrier envelopes.

In proposed § 229.31(a)(4), the Board proposes to retain a portion of the undesignated paragraph in current § 229.30(a) regarding the effect of proposed § 229.31 on a paying bank's deadlines. Proposed § 229.31(a)(4) provides that proposed § 229.31 does not affect a paying bank's responsibility to return a check within the deadlines required by the UCC, Regulation J (12 CFR part 210), or current § 229.30(c) relating to the midnight deadline extension.

b. Section 229.31(b) - Expeditious return of checks by paying bank (or reserved)

Proposed § 229.31(b) under Alternative 1 would be reserved. Proposed § 229.31(b) under Alternative 2 would incorporate the provisions of

current § 229.30(a) imposing the duty of expeditious return on paying banks. Proposed § 229.31(b)(1) under Alternative 2 would set forth the general rule for expeditious return of checks: a paying bank must return the check in an expeditious manner such that the check would normally be received by the depositary bank not later than 2:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank. Proposed § 229.31(b) under Alternative 2 would move up the cutoff hour for receipt of a returned check from 4:00 p.m. to 2:00 p.m. (local time of the depositary bank), consistent with similar changes elsewhere in the current proposal.

Proposed § 229.31(b)(2) under Alternative 2 would provide that, where the second business day following presentment is not a banking day for the depositary bank, a paying bank must send the returned check in a manner such that the depositary bank would *normally* receive the returned check on or before the depositary bank's next banking day.

c. Section 229.31(c) – Exceptions to expeditious return by paying bank (or reserved)

Proposed § 229.31(c) under Alternative 1 would be reserved. Proposed § 229.31(c) under Alternative 2 would incorporate provisions from current § 229.30(b) and current § 229.30(e) regarding exceptions for paying banks to the duty of expeditious return. Specifically, Alternative 2 would include three exceptions to the expeditious-return rule: (1) the paying bank does not have an agreement to send electronic returned checks directly to the depositary bank or to a returning bank that is subject to the expeditious return requirement under proposed

§ 229.32(b); (2) the check is being returned to a depositary bank that is not subject to subpart B; and (3) the check is being returned to an unidentifiable depositary bank. As in the 2011 proposal, proposed § 229.31(c) would group the exceptions to the expeditious return requirement together in one paragraph.

No agreements for direct or indirect electronic return. Under Alternative 2, a paying bank would not be subject to the expeditious-return requirement if the paying bank did not have an agreement to send electronic returned checks to the depositary bank or to a returning bank that is subject to the expeditious return requirement under § 229.32(b).[65] A paying bank would not be subject to the expeditious-return requirement where the depositary bank did not agree to accept return checks electronically. In addition, a paying bank would not be subject to the expeditious-return requirement where the paying bank did not agree to send returned checks electronically. Thus, a paying bank could avoid the expeditious-return requirement under Alternative 2 by choosing to send returned checks only in paper form. The possibility that a paying bank would choose to send returned checks only in paper form in order to avoid the expeditious-return requirement, however, seems unlikely given that paying banks will have a cost incentive to return checks electronically whenever possible. In addition, a paying bank would be subject to the expeditious-return requirement under Alternative 2 if it had the necessary agreements to send electronic returned checks but nevertheless chose to send paper returned checks.

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[65] See the discussion of proposed § 229.32(b) in Alternative 2 below for how returning banks otherwise agree to handle returned checks expeditiously.

For example, assume that the paying bank has an agreement to send electronic returned checks to Returning Bank A. Returning Bank A, however, does not have an agreement to send electronic returned checks directly or indirectly to the depositary bank. Returning Bank A has not otherwise agreed to handle the returned check expeditiously. Under these facts, the paying bank would not be subject to the expeditious return requirement under § 229.31(b). The paying bank, however, must comply with any deadlines under the UCC, Regulation J (if sent through the Reserve Banks), or proposed § 229.31(e) (Extension of deadline).

The UCC and Regulation J (if sent through the Reserve Banks) impose requirements on when a returned check must be dispatched by the paying bank, but do not impose requirements as to when the returned check must be received by the depositary bank. Proposed § 229.31(g), discussed below, would impose requirements on the timing of receipt of a returned check by the depositary bank, but only to the extent the paying bank wishes to avail itself of the extension—that is, if the paying bank sends the returned check after its midnight deadline. Therefore, the Board requests comment on whether Alternative 2 should impose a limit—longer than two business days—on the timeframe within which a *paper* returned check must be received by the depositary bank.

d. Section 229.31(d) – Notice of nonpayment (or reserved)

Proposed § 229.31(d) under Alternative 1 would set forth provisions from current § 229.33(a) and current § 229.33(b) relating to notice of nonpayment. Proposed § 229.31(d) under Alternative 2 would be reserved.

Alternative 1 would retain a notice of nonpayment requirement. Proposed § 229.31 under Alternative 1 would set forth the provisions pertaining to a paying bank's responsibility to provide notice of nonpayment, and proposed § 229.33 would set forth the provisions pertaining to a depositary bank's responsibility to accept such notice.

Notice-of-nonpayment requirement (§ 229.31(d)(1)). Regulation CC currently requires that, if a paying bank determines not to pay a check in the amount of $2,500 or more, it must provide notice of nonpayment such that the notice is received by the depositary bank by 4:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank. Under Alternative 1 of the current proposal, the notice of nonpayment requirement would apply only if the paying bank sends the returned check in paper form. The notice requirement, however, would apply regardless of the dollar amount of the check being returned.

Also under Alternative 1, the Board also proposes to move up the deadline by which a notice of nonpayment must be received by the depositary bank from 4:00 p.m. to 2:00 p.m. (local time of the depositary bank), on the second business day following the banking day of presentment. The proposed 2:00 p.m. deadline would be consistent with banks' generally applicable cutoff hour for receipt of checks under § 4-108 of the UCC, after which a bank may consider an item to be received on its next banking day.

The Board recognizes that the proposed earlier deadline by which the notice must be received by the depositary bank may impose additional cost on the paying

bank sending the notice. The Board believes it is appropriate, however, for this cost to rest with a paying bank that sends a paper return in order to encourage paying banks to send returns electronically (and thereby avoid the notice requirement). At the same time, the proposed earlier time of 2:00 p.m. would benefit depositary banks, because they would learn sooner of the nonpayment of returned paper checks. The Board requests comment on whether the earlier deadline is likely to impose additional costs on paying banks and the extent of any such additional costs.

The proposed 2:00 p.m. deadline should also speed up the time within which the depositary bank's *customer* learns of a check's nonpayment. Regulation CC currently requires a depositary bank receiving a returned check or notice of nonpayment to notify its customer of the fact of return by midnight of the banking day following the banking day on which it received the returned check or notice. If the depositary bank receives notice at 3:00 p.m. on Monday – a time of day that is permissible under the current rule – then it may consider the notice received on its next banking day, Tuesday, such that it need not give notice to its customer until midnight of the night between Wednesday and Thursday. Under Alternative 1, however, a depositary bank receiving notice of nonpayment by 2:00 p.m. on Monday would be required to consider that notice received on Monday and therefore would be required to give notice to its customer by midnight of the night between Tuesday and Wednesday. This faster notice of nonpayment to the depositary bank's customer may benefit the customer by facilitating the customer's ability to contact, and obtain payment from, the drawer of the returned check.

Regulation CC currently permits a paying bank to satisfy the notice-of-nonpayment requirement by returning the returned check itself, provided that the returned check reaches the depositary bank by the deadline for receipt of such notices. The commentary to current § 229.33[66] provides that "[i]n determining whether the returned check will satisfy the notice requirement, the paying bank may rely on the availability schedules of returning banks as the time that the returned check is expected to be delivered to the depositary bank, unless the paying bank has reason to know the availability schedules are inaccurate." This statement in the commentary, however, appears inconsistent with the regulatory text providing for a fixed deadline for the depositary bank's receipt of notice of nonpayment. Therefore, the proposed commentary to proposed § 229.31(d) at paragraph 1.d. would delete this statement. The Board requests comment on whether the fixed deadline is appropriate or whether the paying bank should be able to comply with the notice requirement by relying on a returning bank's availability schedule.

The last sentence of current § 229.33(a) provides that notice of nonpayment may be provided by any reasonable means, including Fedwire, telex, or other form of telegraph. The Board believes that Fedwire, telex, or other form of telegraph are very seldom, if ever, used, and accordingly proposed § 229.31(d)(1) would delete those references. The use of these means of providing notice would nonetheless remain acceptable under the Board's proposal, and a depositary bank's acceptance of such

[66] 12 CFR Part 229, Appendix E, at paragraph XIX.A.3.

notices would be governed by proposed § 229.33(a) and proposed § 229.33(b), discussed *infra*.

The commentary to current § 229.33(a)[67] refers to current § 229.38(b). As discussed in more detail in connection with proposed § 229.38, Alternative 1 would eliminate current § 229.38(b). Accordingly, the proposed commentary to proposed § 229.31(d) at paragraph 1.e. deletes the reference to § 229.38(b).

Content of notices (§ 229.31(d)(2)). Current § 229.33(b) requires a paying bank to include the following information in a notice of nonpayment: (1) the name and routing number of the paying bank; (2) the name of the payee; (3) the amount of the check being returned; (4) the date of the indorsement of the depositary bank; (5) the account number of the depositary bank's customer; (6) the depositary bank's branch name or number; (7) the trace number associated with the indorsement of the depositary bank; and (8) the reason for nonpayment. Proposed § 229.31(d)(2)(i) would revise this provision to state that a paying bank must include the specified information in a notice of nonpayment only to the extent it is available to the paying bank.[68]

Proposed § 229.31(d)(2)(i) would further revise the provisions of current § 229.33(b) to include, to the extent available to the paying bank, the information contained in the check's MICR line when the check is received by the paying bank. The 2011 proposal requested comment on whether notices in lieu of return should

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[67] 12 CFR Part 229, Appendix E, at paragraph XIX.A.4.

[68] Proposed § 229.31(d)(2)(ii) would retain the provisions of the undesignated portion of current § 229.33(b) stating that, if the paying bank is not sure of the accuracy of an item of information, it shall include the required information to the extent possible and identify any item of information for which the bank is not sure of the accuracy.

include, if available, the information from the original check's MICR line. The current proposal would require the MICR line information as specified above to be included in both notices of nonpayment and notices in lieu of return. Accordingly, the comments received on the 2011 proposal with respect to inclusion of MICR line information in notices in lieu of return are addressed here in the context of proposed § 229.31(d)(2)(i).

The Board received nine comments on the provisions of the 2011 proposal related to the information that is required to be included in a notice in lieu of return. All of these commenters, including the group letter, suggested that information from the original check's MICR line be included when providing notices. The current proposal adopts this suggestion of the commenters.

As noted above, proposed § 229.31(d)(2) would require that a notice of nonpayment include the information from the MICR line of the check at the time the check is received by the paying bank, if such information is available. The check's MICR line would typically include the account number of the paying bank's customer, the check's serial number, and, if the check is a corporate-sized check, the auxiliary-on-us field. Proposed § 229.31(d)(2)(i)(A) would therefore delete the reference in current § 229.33(b)(1) to including the paying bank's routing number, because the paying bank's routing number would already be set forth in the MICR line of the check. In addition, proposed § 229.31(d)(2)(i)(F) would set forth the provisions of the undesignated paragraph following current § 229.33(b)(8) requiring that the branch name or number of the depositary bank from its indorsement.

The Board recognizes that requiring MICR line information (if available) to be included in a notice of nonpayment may impose additional cost on a paying bank providing such notices. The Board believes, however, that requiring the information from the MICR line in the notice of nonpayment would benefit the depositary bank by improving its ability to research the check and determine the account into which the check was deposited.

Proposed § 229.31(d)(2)(i)(E) retains the provision of current § 229.33(b)(5) requiring a notice of nonpayment to include the account number of the customer(s) of the depositary bank. The Board requests comment on how often that information is available to the paying bank returning a check. In addition, proposed § 229.31(d)(2)(i)(A) retains the provision of current § 229.33(b)(1) requiring a notice of nonpayment to include the name of the paying bank. Under proposed § 229.31(h), however, a check payable at or through a paying bank would be considered to be drawn on that bank. The Board requests comment on whether a depositary bank receiving a notice of nonpayment or a notice in lieu of return would ever need to know the name of the bank holding the account on which the check is drawn. More generally, the Board requests comment on whether any of the information in current § 229.33(b) or proposed § 229.31(d)(2)(i) required to be included in a notice of nonpayment (if available) should no longer be required.

Depositary banks that are not subject to subpart B (§ 229.31(d)(3)(i)). Proposed § 229.31(d)(3)(i) would provide that the notice-of-nonpayment requirement would not apply with respect to checks that were deposited "in a depositary bank that is not subject to subpart B of this part." The commentary to current § 229.30(e)

clarifies that depositary banks without "transaction-type 'accounts'" need not comply with the funds-availability requirements of subpart B.[69] In addition, although Federal Reserve Banks, Federal Home Loan Banks, private bankers, and possibly certain industrial banks are not subject to the funds-availability requirements of subpart B because they are not "depository institutions" under EFA Act, Regulation CC currently imposes an expeditious-return requirement[70] and a notice-of-nonpayment requirement[71] on checks being returned to those banks. Proposed § 229.31(d)(3)(i) would provide that a paying bank would have no notice-of-nonpayment requirement if the check is being returned to a depositary bank that is not subject to subpart B, either because the depositary bank does not maintain "accounts" or because the depositary bank is not a "depository institution" under the EFA Act. Proposed § 229.31(d)(3)(i) is intended to recognize that these institutions do not bear the same risk of untimely notice of return as banks that are subject to the funds-availability requirement.

Unidentifiable depositary bank (§ 229.31(d)(3)(ii)). Current § 229.30(b) provides that the expeditious-return requirement of that section does not apply to the paying bank's return of a check if the depositary bank is unidentifiable. However, current § 229.33 does not exempt a paying bank from the notice-of-nonpayment requirement even if the paying bank is unable to identify the depositary bank.

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[69] 12 CFR Part 229, Appendix E, at paragraph XVI.E.1. ("Subpart B of this regulation applies only to 'checks' deposited in transaction-type 'accounts.' Thus, a depositary bank with only time or savings accounts need not comply with the availability requirements of Subpart B").
[70] See 12 CFR Part 229, Appendix E, at paragraph XVI.E.2. (expeditious return).
[71] Current § 229.33(e) exempts only depositary banks without transaction-type accounts from the notice-of nonpayment requirement.

Proposed § 229.31(d)(3)(ii) would provide that the notice-of-nonpayment requirement does not apply if the paying bank cannot identify the depositary bank with respect to the returned check.[72] It is unlikely that a paying bank would be able to send a notice-of-nonpayment within the timeframe specified by proposed § 229.31(d) if the paying bank cannot identify the depositary bank. The Board requests comment on the proposed approach, as well as on whether any timing requirement should apply for delivery of notices of nonpayment in connection with a returned check for which the depositary bank is unidentifiable.

e. Section 229.31(e) – Identification of returned check

Current § 229.30(d) states that "[a] paying bank returning a check shall clearly indicate on the face of the check that it is a returned check and the reason for return. If the check is a substitute check, the paying bank shall place this information within the image of the original check that appears on the front of the substitute check." In the 2011 proposal, the Board proposed that, if a returned check is a substitute check or electronic return, the paying bank must indicate the reason for the return in such a manner that the information would be retained on any subsequent substitute check, instead of requiring the reason for the return to be placed within the image of the original check. The Board intended with this proposal to provide the industry with greater flexibility as to the placement of the reason for return while also ensuring that

[72] Proposed § 229.31(d)(3)(ii) is consistent with the statement in the commentary to current § 229.33(b), stating that if a paying bank cannot identify the depositary bank, it may wish to send the notice to the earliest collecting bank it can identify, but that the collecting bank is under no duty to identify the depositary bank and forward the notice. 12 CFR Part 229, Appendix E, at paragraph XIX.B.2.

the reason for return would be retained on any subsequent substitute check.[73] The two commenters responding to this aspect of the proposal, including the group letter, both supported it.

The provisions of the current proposal are very similar to those of the 2011 proposal with regard to the identification of returned checks. Proposed § 229.31(e) would provide that, if the paying bank is returning a substitute check or an electronic returned check, the paying bank shall identify the check as a returned check and include the reason for return such that the information be retained on any subsequent substitute check.

The Board also proposed in the 2011 proposal to amend the commentary to current § 229.30(d)[74] to state that "refer to maker" is insufficient by itself as a reason for return, because "refer to maker" is an instruction to the recipient of the returned check and not a reason for return (e.g., insufficient funds). One commenter on this aspect of the 2011 proposal agreed that "refer to maker" is insufficient as a reason for return. The other approximately 20 commenters on this aspect of the proposal, including the group letter, uniformly opposed the proposed revision. Commenters noted that "refer to maker" is used as a catch-all to cover various reasons for return, such as for suspected fraud, no match in a positive-pay file provided by the drawer, or in connection with registered warrants issued by states.[75] These commenters noted

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[73] 76 FR 16862, 16877 (Mar. 25, 2011).

[74] 12 CFR Part 229, Appendix E, at paragraph XVI.D.1.

[75] Commenters stated that in some cases in which a positive-pay system is used, the paying bank does not know its customer's factual basis for instructing the paying bank to return the check and, in these cases, "refer to maker" serves as a necessary means to instruct the payee to contact the drawer to for determine the reason the check was not paid.

that industry standards do not currently permit using “refer to maker” as a reason for return in addition to another reasons, and that, therefore, accommodating the proposed elimination of the “refer to maker” reason for return would require system and process modifications by both the banks and the customers that use these systems. These commenters stated that these changes would be costly and take about two years to implement. A few commenters recognized that, in the past, there has been some abuse of using “refer to maker,” but that such abuse is less of a problem in recent years. Other commenters stated that the Board did not sufficiently explain any changes in circumstances that would warrant no longer permitting “refer to maker” to be used as a reason for return.

After consideration of the comments received in response to the 2011 proposal, the Board continues to believe that “refer to maker” is an instruction to the recipient of the returned check, but recognizes that there may be circumstances in which it may be necessary for “refer to maker” to be used as the reason for return. Accordingly, the commentary to proposed § 229.31(e) would provide greater clarity on the circumstances in which “refer to maker” by itself may be used as a reason for return, such as when a drawer with a positive pay arrangement instructs the bank to return the check. Additionally, the commentary to proposed § 229.31(e) would include an example of when “refer to maker” would not be permissible; specifically, in cases where a check is being returned due to the paying bank having already paid the item. The Board believes that, in such cases, the payee and not the drawer would have more information as to why the check is being returned.

f. Section 229.31(f) – Notice in lieu of return

Current § 229.30(f) provides that, if a check is unavailable for return, the paying bank may send in its place a copy of the front and back of the returned check, or, if no such copy is available, a written notice of nonpayment containing the information specified in current § 229.33(b). The 2011 proposal would have revised the commentary to the notice-in-lieu provisions to provide that a bank may send a notice in lieu of return only where neither the check itself nor an image of and information related to the check sufficient to create a substitute check is available. In addition, the 2011 proposal would have amended the commentary to provide that, if no image of both sides of the check is available, the notice in lieu may be sent by written electronic transmission,[76] so long as it contained the required information. The 2011 proposal, like the current regulation, would not have permitted notice in lieu of return by telephone or other similar oral transmission. The 2011 proposal proposed to leave the information requirements for a notice in lieu of return unchanged. The Board requested comment, however, on whether the information-content specifications for a notice in lieu of return should be revised to include the information from the original check's MICR line. Further, as an alternative approach, the Board requested comment on whether the regulation's provision for notice in lieu of return should be deleted.

All 12 commenters that addressed the 2011 proposal's provisions related to notices in lieu of return believed that the notices remain necessary in certain

[76] E.g., by being sent electronically through the ACH system or the check system, if permitted by applicable rules and standards.

circumstances and recommended that the Board retain the provisions related to notices in lieu of return. Nine of these commenters, including the group letter, stated that the notices should include the information from the original check's MICR line, if available, because that information is helpful to the depositary bank in locating the item. The group letter suggested that the Federal Reserve work with the banking industry to develop common standards for electronic notices in lieu of return in order to facilitate their use. Most commenters opposed sending notices in lieu of return through the ACH network.[77]

After considering the comments received on the 2011 proposal, the Board currently proposes to revise the information required to be included in a notice in lieu of return and in a notice of nonpayment. Specifically, proposed § 229.31(f) under Alternative 1 would require the paying bank to send a copy of the front and back of the returned check or, if no such copy is available, a written notice of nonpayment containing the information required in proposed § 229.31(d)(2). Alternative 2, as noted above, does not contain a notice-of-nonpayment requirement. Accordingly, proposed § 229.31(f) under Alternative 2 would require the paying bank to include the information from the original check's MICR line, to the extent that information is available, in such notices.[78] The information from the original check's MICR line typically would be included in electronic information, even if the accompanying electronic image were illegible. The current proposed commentary to proposed § 229.31(f) is the same as that set forth in the 2011 proposal: If no image of both

[77] The National Automated Clearing House Association (NACHA) noted in its comment letter that it had found there to be insufficient support for this possibility from financial institutions to begin considering revising its rules to support it.

sides of the check is available, the notice in lieu may be sent by electronic transmission, so long as it contains the required information. As under current § 229.30(f), proposed § 229.31(f) would require notice in lieu to be in writing and would not permit notice in lieu of return by telephone or other similar oral transmission. In addition, the proposed commentary to proposed § 339.31(f) would clarify that a bank may send a notice in lieu of return as an electronic image of both sides of the check only if it has an agreement to do so with the receiving bank.

a. Section § 229.31(g) – Extension of deadline

Current § 229.30(c) provides that a paying bank's deadline (as set forth in either the UCC, Regulation J (12 CFR part 210), or § 229.36 of Regulation CC) to initiate the return of a check is extended to the time at which a paying bank dispatches the return, if the paying bank uses a means of delivery that ordinarily would result in receipt by the bank to which the return is sent on or before the receiving bank's next banking day following the day of the applicable deadline by the earlier of the close of that banking day or a 2:00 p.m. cutoff hour (or such later time as set by the receiving bank under UCC 4–108).[79] The 2011 proposal would have extended a paying bank's return deadline only if the paying bank sent the return such that the returned check would be ordinarily be received by the depositary bank within the two-day timeframe mandated in the proposed expeditious-return test; that is, by 4:00 p.m. (local time of the depositary bank) on the second business day following presentment to the paying bank. The 2011 proposal requested comment, however, on whether the deadline

[79] The current paragraph provides a further extension if the paying bank uses a ''highly expeditious'' means of return, or if the paying bank's deadline for return falls on a Saturday that is a banking day for the paying bank under the UCC. (Saturday is never a banking day under Regulation CC.)

extension should require the return *actually* to reach the depositary bank within the two-day timeframe for the extension to apply.

All seven commenters addressing this aspect of the proposal, including the group letter, supported requiring actual receipt by the depositary bank within the specified timeframe, on the grounds that paying banks should use the extension sparingly; requiring actual receipt of the check would place squarely on the paying bank the risk associated with using the extension.

Current § 229.30(c) provides for extension of the deadline where the paying bank uses a means of delivery that would ordinarily result in receipt by the bank to which it is sent within the specified timeframe. Proposed § 229.31(g) would provide that a paying bank may avail itself of the extension of the deadline only if the returned check is *actually* received by the depositary bank (or in the case of an unidentifiable depositary bank, the bank to which the return is sent) within the specified timeframe.[80] Proposed § 229.31(g) would establish that returned checks must be received by the depositary bank or receiving bank by the earlier of the close of the banking day or a cutoff hour of 2:00 p.m. (local time of the depositary bank or receiving bank) or later set by the depositary bank or receiving bank.

Proposed § 229.31(g) would also provide that the extension of the deadline applies to the extension of deadlines for return of the check or notice of dishonor or nonpayment under the UCC. Proposed § 229.31(g) is intended to distinguish notice of dishonor or nonpayment under the UCC from notice of nonpayment under

[80] Proposed § 229.31(g) is included in both Alternative 1 and Alternative 2, even though Alternative 1 would eliminate the expeditious-return requirement.

Regulation CC. The Board does not intend any substantive change. Proposed § 229.31(g) would also eliminate the provisions of current § 229.30(c)(1) providing for further extension of the deadline if the paying bank uses a "highly expeditious" means of transportation. Electronic delivery of returned checks by paying banks has become the norm, and such delivery of a returned check results in its receipt by a returning bank even faster than does the commentary's current examples of "highly expeditious" transportation.[81] Therefore, the Board believes that a paying bank should no longer be afforded an additional deadline extension if it ships a returned check by air courier.

b. Section 229.31(h) – Payable-through and payable-at checks

Current § 229.36(a) provides that a check payable at or through a paying bank is considered to be drawn on that bank for purposes of subpart C's expeditious-return and notice-of-nonpayment requirements. The Board proposes to move these provisions to proposed § 229.31(h), and, under Alternative 1, to remove the paragraph's reference to expeditious return. Under Alternative 1, notice of nonpayment would be the only subpart C requirement to which § 229.31(h) would apply to payable-at and payable-through banks.[82]

c. Section 229.31(i) – Reliance on routing number

Current § 229.30(f) provides that a paying bank may return a check based on any routing number designating the depositary bank appearing on the check in the

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[81] The example of "highly expeditious" means of transportation in the current commentary is a West Coast paying bank using an air courier to ship a returned check directly to an East Coast returning bank. 12 CFR Part 229, Appendix E, at paragraph XVI.C.1.a.

[82] A check sent for payment or collection to a payable-through or payable-at bank is not considered to be drawn on that bank for purposes of the midnight deadline provision of U.C.C. § 4-301.

depositary bank's indorsement. The 2011 proposal would have revised the commentary to current § 229.30(f) to provide that a paying bank may rely on any routing number designating the depositary bank in the electronic image of or information related to the check. The group letter supported that proposed addition, and the Board's current proposal includes substantially similar language in the proposed commentary to § 229.31(i).

One Reserve Bank commenter stated that, in addition to permitting the paying bank to rely on any routing number designating the depositary bank that appears on the check or in the associated electronic image or information, the Board should prohibit any bank that is identified as a depositary bank on the returned check or in the electronic returned check from sending the return back to the returning bank or the paying bank or otherwise treating the returned item as "not our item" (an NOI), such as through the Reserve Banks' adjustment procedures. The Board requests comment on whether such a prohibition should be incorporated into the regulation.

3. Section 229.32 – Returning bank's responsibility for return of checks

a. Section 229.32(a) – Return of checks

Current § 229.31(a) sets forth a returning bank's expeditious-return requirement. The undesignated paragraph in current § 229.31(a) provides that a returning bank may send a returned check to the depositary bank or to any other bank agreeing to handle the returned check expeditiously. The same undesignated paragraph also provides that a returning bank may create a qualified returned check (and sets forth format standards for qualified returned checks) and provides a one-business-day extension under the forward-collection test and deadline for return

under the UCC and Regulation J if the returning bank creates a qualified returned check. The extension does not apply to the two-day/four-day test or to checks returned directly to the depositary bank.

Proposed § 229.32(a) would retain the provisions of the undesignated paragraph in current § 229.31(a) described above, subject to the revisions discussed below. For the reasons discussed above, Alternative 1 would eliminate the requirement that a returning bank return a check expeditiously. Accordingly, Alternative 1 would delete the two-day/four-day and forward-collection tests of current § 229.31(a), and would eliminate all references to expeditious return from the regulation and accompanying commentary. Alternative 2 would retain a modified expeditious-return requirement in proposed § 229.32(b).

Under Alternative 1, proposed § 229.32(a)(1) would permit a returning bank to send a returned check to the depositary bank, to any bank agreeing to handle the returned check, or as provided in proposed paragraph § 229.32(a)(2) if the depositary bank is unidentifiable. Retaining this provision continues to permit returning banks to return checks using more direct paths to depositary banks than permitted under the UCC § 4-301(d). Proposed § 229.32(a)(1) under Alternative 2 would be the same as under Alternative 1, subject to the duty of expeditious return.

The Board proposes to clarify in the commentary that a returning bank may send an electronic returned check directly to the depositary bank only if the returning bank has an agreement with the depositary bank to do so. The Board proposes to retain the language in the current commentary stating that a returning bank agrees to handle a returned check if the returning bank publishes or distributes availability

schedules for the return of checks and accepts the returned check for return; handles a returned check that it did not handle for forward collection; or otherwise agrees to handle a returned check for expeditious return.[83] The Board proposes to add that a returning bank agrees to handle a returned check if it agrees with the paying bank to handle electronic returned checks sent by the paying bank.

Under both Alternative 1 and Alternative 2, proposed § 229.32(a)(2) would set forth provisions relating to a returning bank's responsibility for a returned check with an unidentifiable depositary bank. Proposed § 229.32(a)(2) would revise the provisions of current § 229.31(b) and accompanying commentary to provide that the returning bank's responsibility is similar to that of a paying bank, for the reasons discussed above in connection with proposed § 229.31(a)(2). Under either Alternative 1 or Alternative 2, a returning bank's return of a check to an unidentifiable depositary bank would not be subject to the expeditious return requirement. Proposed § 229.32(a)(3) would retain the provisions of the undesignated paragraph in current § 229.31(a) that permit returning banks to qualify returned checks and that instruct returning banks on how to do so. As noted above, all commenters on the qualified return check provisions of the 2011 proposal indicated that the need still exists for qualified returns and carrier envelopes, and that there would be costs associated with implementing alternative methods for returning checks that currently are prepared as qualified returns or use carrier envelopes. Like the 2011 proposal, however, the current proposal would delete the provisions of the

[83] In Alternative 2, the commentary to proposed § 229.32(b) describes the circumstances under which a returning bank agrees to handle a returned check expeditiously.

undesignated paragraph of current § 229.31(a)(2) permitting a one-business-day extension for return for converting a returned check to a qualified returned check. The Board received no comments addressing the proposed elimination of the extension in response to the 2011 proposal. The extension, if retained, might benefit returning banks that choose to qualify and send paper returned checks destined for depositary banks that have agreed to accept returns electronically, a result that is inconsistent with the policy of encouraging electronic return of checks. In addition, if a returned check is destined for a depositary bank that does not accept returned checks electronically, the Board believes that a returning bank's midnight deadline affords it sufficient time to process and send the returned check, irrespective of whether the returning bank qualifies the returned check or not.[84]

b. Section 229.32(b) – Expeditious return of checks by returning bank (or reserved)

Under Alternative 1, § 229.32(b) would be reserved. Under Alternative 2, proposed § 229.32(b)(1) would set forth the general rule for expeditious return of checks: a returning bank must return the check in a manner such that the check would normally be received by the depositary bank not later than 2:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank.[85] Proposed § 229.32(b)(2) would parallel proposed § 229.31(b)(2), which sets forth the return deadline for paying banks under

[84] The Board is proposing to delete the return-deadline extensions for creating qualified returned checks under proposed Alternatives 1 and 2.

[85] Consistent with the other proposed changes to the receipt deadlines, the Board proposes to move up the cutoff hour for receipt of a returned check from 4:00 p.m. to 2:00 p.m. (local time of the depositary bank).

circumstances where the second business day following presentment is not a banking day for the depositary bank. Alternative 2 would delete the provisions of current § 229.31(a) setting forth the four-day test and the forward-collection test, as well as remove all references to those tests throughout the regulation and related commentary.

The proposed commentary to § 229.32(b) under Alternative 2 would provide examples of when a returning bank is subject to the expeditious return requirement with respect to a returned check. The first examples are situations in which the returning bank itself is subject to the expeditious return requirement, specifically, where the returning bank has an agreement to send electronic returned checks directly to the depositary bank, to another returning bank that has an agreement to send electronic returned checks to the depositary bank, or to another returning bank that otherwise agrees to handle the returned check expeditiously under § 229.32(b). Additionally, a returning bank could agree to handle a returned check for expeditious return if the returning bank publishes or distributes availability schedules for the return of returned checks to the depositary bank and accepts the returned check for return. A returning bank also could agree with the paying bank or another returning bank to handle returned checks sent by the paying bank or other returning bank for expeditious return to certain depositary banks. Like the 2011 proposal, the proposed revisions to the commentary on proposed § 229.32(b) would explain that a returning bank could accept a paper returned check that it did not handle for forward collection without being deemed to have agreed to handle the returned check for expeditious return.

The proposed commentary would retain the language in the current commentary[86] stating that a returning bank agrees to handle a returned check if the returning bank publishes or distributes availability schedules for the return of returned checks and accepts the returned check for return; handles a returned check for return that it did not handle for forward collection; or otherwise agrees to handle a returned check for expeditious return.[87] The proposed commentary to proposed § 229.32(b) would include a clarification that a returning bank agrees to handle a returned check if it agrees with the paying bank to handle electronic returned checks sent by the paying bank.

(c) Section 229.32(c) – Exceptions to expeditious return of checks by returning bank (or reserved)

Proposed § 229.32(c) would be reserved under Alternative 1. Proposed § 229.32(c) under Alternative 2 would include exceptions to the expeditious-return requirement similar to those set forth forth for paying banks in proposed § 229.31(c) under Alternative 2: the expeditious-return requirement would not apply if (1) the returning bank does not have an agreement to send electronic returned checks directly or indirectly to the depositary bank; (2) the check is being returned to a depositary bank that is not subject to subpart B of this regulation; and (3) the check is being returned to an unidentifiable depositary bank. As in the 2011 proposal, proposed § 229.32(c) under Alternative 2 would be grouped together in one paragraph.

[86] 12 CFR Part 220, Appendix E, at paragraph XVII.A.2.a.

No agreements for direct or indirect electronic return. For the reasons set forth in more detail above with respect to paying banks, proposed § 229.32(c) would not subject a returning bank to the expeditious-return requirement if the returning bank did not have an agreement to send electronic returned checks to the depositary bank, to a returning bank that has an agreement to send electronic returned checks to the depositary bank, or to a returning bank that otherwise agrees to handle the returned check expeditiously under proposed § 229.32(b) under Alternative 2. As with paying banks in proposed § 229.31(c) under Alternative 2, a returning bank would be subject to the expeditious-return requirement if the returning bank had the necessary agreements to send electronic returned checks but chose to send paper returned checks.

The proposed commentary to § 229.32(c)(1) would explain that the expeditious-return requirement would not apply to a returning bank if: the returning bank did not have an agreement to send electronic returned checks to the depositary bank, and did not have an agreement to send electronic returned checks to another returning bank that had an agreement to send electronic returned checks to the depositary bank. By contrast, if the returning bank to which the paying bank sent the returned check had an agreement to send electronic returned checks directly to the depositary bank or to another bank that had an agreement to send electronic returned checks directly to the depositary bank, the first returning bank would be subject to the expeditious-return requirement under proposed § 229.32(b). Under the latter circumstances, a check is presented to the paying bank on Monday would have to be sent by the returning bank in a manner such that the depositary bank normally would

receive the returned check by 2:00 p.m. (local time of the depositary bank) on Wednesday.

Depositary bank not subject to subpart B and unidentifiable depositary bank. Proposed § 229.32(c)(1) under Alternative 2 would retain the exceptions to the expeditious-return requirement for checks deposited into a depositary bank that does not maintain "accounts" and checks where the paying bank (or returning bank) is unable to identify the depositary bank. Additionally, for the same reasons as set forth in connection with proposed § 229.32(c)(2) under Alternative 2 (and in connection with the exceptions to the notice-of-nonpayment requirement set forth in proposed § 229.32(d)(3) under Alternative 1), proposed § 229.32(c) under Alternative 2 would expand the circumstances under which a returning bank is not subject to the expeditious-return requirement to include circumstances where a returning bank is returning a check to a depositary bank that is not subject to subpart B of Regulation CC because the bank is not a "depository institution" within the meaning of the EFA Act.

Similar to the provisions of the 2011 proposal, proposed § 229.32(c) under Alternative 2 would provide that a returning bank that receives a returned check for which the paying bank was unable to identify the depositary bank would not be subject to the expeditious-return requirement, even though the returning bank may be able to identify the depositary bank. Under those circumstances, it likely would be difficult for the returning bank to meet the two-day test because the paying bank likely would have sent the returned check as if it were not subject to the expeditious-return requirement. A returning bank would still be required to use

ordinary care when returning the item.[88] The proposed commentary to proposed § 229.32(c) under Alternative 2 would include the revised examples of the circumstances under which a returning bank is unable to identify the depositary bank, discussed in connection with proposed § 229.31(a)(2) for paying banks.

d. Section 229.32(d) – Notice in lieu of return

The notice in lieu of return requirements for returning banks are the same for returning banks as they are for paying banks. Under both Alternative 1 and Alternative 2, proposed § 229.32(d) and the related proposed commentary would make changes that parallel those discussed in connection with proposed § 229.31(f) for paying banks, for the reasons discussed above in connection with proposed § 229.31(f).[89]

e. Section 229.32(e) – Settlement

Like the 2011 proposal, the current proposal at proposed § 229.32(e) would not amend the current provisions of Regulation CC setting forth a returning bank's settlement obligation for returned checks.[90] The proposed commentary to proposed § 32(e) would provide clarifying revisions.

f. Proposed § 229.32(f) – Charges

The 2011 proposal would have clarified that the party on which a returning bank may impose a charge for handling a returned check is the bank that sent the returned check to it, rather than another party. One commenter supported the

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[88] U.C.C. § 4-202.
[89] Were the Board to adopt proposed Alternative 2, a returning bank's sending of a notice in lieu of return would be subject to the expeditious return requirement.
[90] 12 CFR § 229.31(c).

proposed clarification. One Reserve Bank commenter, however, suggested that the Board should eliminate prohibitions on fees that banks may charge to each other for handling checks. The commenter was concerned that prohibitions on fees might stifle innovation in the development of bank-to-bank practices and services related to handling checks electronically.

Proposed § 229.32(f) would not amend the provisions of current § 229.31(d) related to charges a returning bank may impose for handling returned checks. The Board requests comment on whether it should eliminate regulatory prohibitions on returning bank fees for returning checks.

g. Section 229.32(g) – Reliance on routing number

The proposed commentary to proposed § 229.32(g) would provide that a returning bank, when returning a check, may rely on any routing number designating the depositary bank in the electronic returned check received by the returning bank. These proposed revisions are similar to those described in connection with the proposed commentary to proposed § 229.31(i), discussed above.

4. Section 229.33 – Depositary bank's responsibility for returned checks and notices of nonpayment.

As in the 2011 proposal, the Board proposes to consolidate the regulation's provisions related to a depositary bank's responsibility for returned checks and notices of nonpayment in one section.

a. Section 229.33(a) – Acceptance of electronic returned checks and electronic notices of nonpayment

Proposed § 229.33(a) would provide that a depositary bank's agreement with the transferor bank governs its acceptance of electronic returned checks and

electronic written notices of nonpayment (as opposed to oral notices of nonpayment, i.e., those provided over the telephone, which are discussed below under proposed § 229.33(c)). The transferor bank may be either the paying bank or a returning bank. Under Alternative 2, the reference to notice of nonpayment would be omitted. The proposed commentary to proposed § 229.33(a) under both Alternative 1 and Alternative 2 would provide that the agreement normally would specify the electronic address or receipt point at which the depositary bank accepts returned checks and written notices of nonpayment electronically, as well as what constitutes receipt of the returned checks and written notices of nonpayment.

b. Section 229.33(b) – Acceptance of paper returned checks and paper notices of nonpayment

Current § 229.32(a)specifies that the locations where a depositary bank must accept returned checks and notices of nonpayment.[91] Similar to the provisions of the 2011 proposal, proposed § 229.33(b) would not incorporate the provisions of current § 229.32(a)(2)(iii), addressing situations where the address in the depositary bank's indorsement is not in the same check-processing region as the address associated with the routing number in its indorsement because there is a single national check-processing region. Proposed § 229.33(b) under both Alternative 1 and Alternative 2 would require a depositary bank that includes its address in its indorsement to receive paper returned checks at a location consistent with that

[91] Current § 229.33(c) provides that § 229.32(a) governs where a depositary bank must accept written notices of nonpayment.

address and at a location, if any, at which it requests presentment of paper checks. The Board received no comments on the similar provisions of the 2011 proposal.

c. Section 229.33(c) – Acceptance of oral notices of nonpayment

Current § 229.33(c) requires a depositary bank to accept oral notices of nonpayment at the telephone or telegraph number of its return check unit indicated in the indorsement (or the general purpose number if no such number appears), as well as at any other number held out by the bank for receipt of notice of nonpayment.[92] Under Alternative 1, proposed § 229.33(c) would provide that a depositary bank must accept oral notices of nonpayment at any telephone number that appears in its indorsement, rather than refer solely to the telephone number of the returned check unit. Under Alternative 2, proposed § 229.33(c) would be reserved.

The commentary to current § 229.33(c) states that the depositary bank may not refuse to accept notices at the telephone numbers provided in this section, but may transfer calls or use a recording device.[93] The Board requests comment on whether a depositary bank that has agreed to accept written notices of nonpayment electronically should be required to also accept oral notices of nonpayment.

d. Section 229.33(d) – Payment for returned checks by depositary banks

Proposed § 229.33(d) sets forth, with minor technical amendments, the provisions of current § 229.32(b) governing a depositary bank's payment for returned checks.

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[92] Similar to proposed § 229.31(d), proposed § 229.33(c) would delete references to using the telegraph as a means of accepting notices.
[93] 12 CFR Part 229, Appendix E, at paragraph XIX.C.1.

e. Section 229.33(e) – Misrouted returned checks and written notices of nonpayment

Proposed § 229.33(e) would retain the provisions of current § 229.32(c) requiring a bank that receives a misrouted returned check or written notice of nonpayment on the basis that it is the depositary bank to send the returned check or notice to the correct depositary bank, to a returning bank agreeing to handle the returned check or notice, or back to the bank from which it received the misrouted return or notice. The Board expects that depositary banks and their transferor banks should be able to address in their agreements the appropriate actions to be taken by the depositary bank in the event it receives a misrouted electronic returned check or written electronic notice of nonpayment. The Board requests comment on what actions depositary banks typically take when they receive a misrouted written electronic notice of nonpayment.

f. Section 229.33(f) – Charges

Proposed § 229.33(f) sets forth without change the provisions of current § 229.32(d) prohibiting a depositary bank from imposing charges for accepting and paying checks being returned to it.

g. Section 229.33(g) – Notification to customer

Proposed § 229.33(g) would amend the provisions of current § 229.33(d)to include the requirement that a depositary bank notify its customer under circumstances where a depositary bank receives notice of recovery under current § 229.35(b) (liability of bank handling a check), which the current proposal does not propose to amend. Currently, this requirement is set forth only in the commentary to

current § 229.32(d).[94] Under Alternative 1, proposed § 229.33(g) would refer to both returned checks and notices of nonpayment. Under Alternative 2, proposed § 229.33(g) would refer only to returned checks.

5. Section 229.34 – Warranties and indemnities

Proposed § 229.30(a) provides that electronic checks and electronic returned checks are subject to the provisions of subpart C as if they are checks. Accordingly, proposed § 229.34 would apply all of the warranties and indemnities in that section to a bank that handles an electronic check or electronic returned check. In addition to those warranties, the Board is proposing that new warranties be made with respect to electronic checks and electronic returned checks.

Content of warranties. Proposed § 229.34(a)(1) would add new warranties to the regulation that would be made by a bank that transfers or presents an electronic check or electronic returned check and receives a settlement or other consideration for it. Under proposed § 229.34(a)(1), the bank would warrant that the electronic image accurately represents all of the information from the original check as of the time the original check was truncated, that the electronic information contains an accurate record of all the MICR line information required for a substitute check under the regulation's substitute check definition,[95] and that no person will receive transfer, presentment, or return of, or otherwise be charged for, the electronic image of or electronic information related to the check or returned check, the original check, a

[94] 12 CFR Part 229, Appendix E, at paragraph XIX.D.1.

[95] 12 CFR § 229.2(aaa).

substitute check, or a paper or electronic representation of a substitute check such that the person will be asked to make payment based on a check it has already paid.

These warranties are substantively the same as those set forth in the 2011 proposal, which commenters supported. All but one commenter suggested that the parties exchanging the electronic image or electronic information should be able to vary the warranties by agreement. The current proposal would clarify in the proposed commentary to proposed § 229.34(a) that the sending bank and receiving bank may vary by agreement the warranties the sending bank makes to the receiving bank for electronic images of or electronic information related to checks. The effect of the variation, however, would extend only to the parties that are bound by the agreement. For example, the banks' agreement may provide that the bank transferring the check does not warrant that the image and information are sufficient for creating a substitute check.

Parties to whom the warranties are made. Similar to the provisions of the 2011 proposal, proposed § 229.34(a)(2)(i) would provide that these warranties would flow, in the case of electronic checks sent for forward collection, to the transferee bank, any subsequent collecting bank, the paying bank, and the drawer of the check. Proposed § 229.34(a)(2)(ii) would provide that, in the case of an electronic returned check, the warranties would flow to the transferee returning bank, any subsequent returning bank, the depositary bank, and the owner of a returned check.

Some commenters on the 2011 proposal opposed extending the warranties to the drawers and the owners, believing that the warranties should be made only between the parties exchanging the items. These commenters stated that, absent the

proposed warranties, banks' customers are adequately protected under the UCC for improper charges to their account (such as paying an item twice). The group letter supported extending the warranties to drawers and owners only if banks were permitted to vary the application of the warranties through operating circular, clearinghouse rules, or customer agreement. The group letter also suggested that the drawer should not be able to recover from a collecting bank unless the drawer first has made a claim against its bank.

The Board believes that proposed § 229.34(a)(2) is consistent with the warranty flow set forth by section 5 of the Check 21 Act and implemented by § 229.52(b) of subpart D, which was intended to protect parties outside the banking system from any undesirable consequences resulting from check truncation. In particular, existing laws, including the UCC, may not adequately protect drawers from harm resulting from illegible images or incorrect MICR lines on electronic checks or returned checks derived from original checks. For example, if the image is illegible, a drawer may not be able to prove that a check charged to the account for $1,500 was in fact written for $150. Moreover, extending the warranties to drawers could protect drawers against losses incurred from being asked to pay an item twice. Finally, extending the warranties to drawers and owners of checks could help the drawer or the owner, respectively, in the event of the failure of the paying bank or depositary bank. The Board requests comment on whether the drawer or owner of a check should be required to make a claim against his or her bank before making a breach of warranty claim against a prior collecting bank.

Under current § 229.37, the banks exchanging electronic checks may vary the effect of the warranties as between themselves, but not with respect to subsequent transferees that are not bound by the agreement. If, however, one of the parties to the agreement must create a substitute check from the electronic check or electronic returned check, such a reconverting bank would not be able to disclaim or vary the substitute check warranties it makes.

6. Section 229.34(b) – Indemnity with respect to an electronic image or electronic information not related to a paper check.

Proposed § 229.34(b) would provide that a bank that transfers an electronic image or electronic information that is not derived from a paper check indemnify the transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim, or damage that results from the fact that the image or information was not derived from a paper check. This proposed indemnity would protect a bank that receives an electronically-created item from a sending bank against any loss or damage that results from the fact that there was no original check corresponding to the item that the sending bank transferred. For example, a paying bank that receives an electronic check file that contains an eRCC might not know the eRCC was not derived from a paper RCC. That paying bank might try to recover losses from an unauthorized eRCC from prior banks that handled the item through procedures offered by collecting banks and check clearinghouses, or the paying bank might make a warranty claim. The paying bank's claims might fail as invalid claims because the eRCC never existed in paper form. The paying bank could seek to be indemnified by the depositary bank under the proposed indemnity in § 229.34(b) for

the losses caused by the fact that the item was electronically created. The proposed amount of this indemnity is set forth in proposed § 229.34(i).

Indemnity recipients. The indemnity in proposed § 229.34(b) would not flow to the drawer, payee or depositary bank of the item. The Board believes that the payee and the depositary bank are in the best position to know whether an item is electronically created and to prevent the item from entering the check-collection system. For electronically-created items, the payee should reasonably be aware that the item was electronically created (either because the payee might have created the item or because the payee received an image instead of a paper check). The Board believes that a depositary bank that accepts an item for deposit electronically should assume the risk that the item was not derived from a paper check. The Board expects that the depositary bank can contractually protect itself by, if necessary, modifying the terms of its agreement with its depositor that permits items to be deposited electronically. Additionally, for items electronically created by the paying bank's customer, the customer introduces the item into the check collection system. Therefore, the Board does not believe it is appropriate for subsequent banks handling the item to indemnify those parties for losses.

In the case of an eRCC, the paying bank's customer, whose account will be debited, may not be aware that the payee created an electronic item rather than a paper item. The warranties in proposed § 229.34(b) would protect the person whose account will be debited because the item never existed in paper. The paying bank's customer, however, should normally be made whole by the paying bank for the unauthorized debit in accordance with UCC § 4-401 or Regulation E (12 CFR part

1005), assuming either is applicable. The Board requests comment on whether it is appropriate for the proposed indemnity to flow to the person whose account will be debited.

7. Section 229.34(c) – Transfer and presentment warranties with respect to a remotely create check

Proposed § 229.34(c) sets forth without substantive change the provisions of current § 229.34(d) relating to the transfer and presentment warranties made with respect to remotely created checks.[96] The proposed commentary to proposed § 229.34(c) would revise the current commentary to current § 229.34(d) to correspond to the Federal Trade Commission's proposed changes to its Telemarketing Sales Rule, were the FTC to adopt the rule as proposed. Among other things, the FTC's proposed amendments would bar sellers and telemarketers from creating RCCs as payment for goods or services.[97] Accordingly, the references in the commentary to the Telemarketing Sales Rule's authorization requirements would be unnecessary if the FTC were to adopt its proposed rule.

8. Section 229.34(d) – Settlement amount, encoding, and offset warranties

In the 2011 proposal, the Board proposed that the information encoded after issue include information placed "in the electronic information" of an electronic item.

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[96] A bank that transfers or presents a remotely created check and receives settlement or other consideration warrants to the transferee bank, any subsequent collecting bank, and the paying bank that the person on whose account the remotely created check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check. *See* proposed § 229.34(c) (current § 229.34(d)).

[97] The FTC's proposed rule is available on the FTC's website at http://www.ftc.gov/os/2013/05/130521telemarketingsalesrulefrn.pdf

This change would have included information in an electronic check or an electronic returned check within the scope of the warranty. Two commenters, including the group letter, supported that proposal. One Reserve Bank commenter noted, however, that the language of the 2011 proposal might be too broad, because it could be read to include data in portions of an item's electronic information other than the MICR line, such as indorsement records. Proposed § 229.34(d)(3) would provide that the information encoded after issue in the MICR line of a check – which is the information to which the warranty applies – means any information that could be encoded in the MICR line of a paper check.

The current proposal, like the 2011 proposal, would provide that a bank warrants that the information encoded after issue is "accurate," instead of "correct." The Board does not intend this change to be substantive.

9. Section 229.34(e) – Returned check warranties

Proposed § 229.34(e), like the similar provisions of 2011 proposal, would remove the warranty in current § 229.34(a)(1) that the paying bank has returned a check within the deadline specified in the Board's Regulation J (12 CFR part 210), because that deadline applies only to checks returned through Reserve Banks, and need not be specified in Regulation CC. The group letter supported this provision of the 2011 proposal.

10. Section 229.34(f) – Notice of nonpayment warranties

Proposed § 229.34(f) under Alternative 1 would retain warranties similar to those set forth in current § 229.34(b) relating to notices of nonpayment. By contrast, the 2011 proposal would have eliminated the notice of nonpayment requirement and

related warranties. Similar to the provisions of proposed § 229.34(e), proposed § 229.34(f) would delete the paying bank's warranty that it will return the check within its deadline under Regulation J, because that deadline applies only to checks returned through Reserve Banks and need not be specified in Regulation CC.

Proposed § 229.34(f)(2) would state explicitly that the notice of nonpayment warranties are not made with respect to checks drawn on the Treasury of the United States or U.S. Postal Service money orders. The U.S. Treasury and Postal Service are not "paying banks" for purposes of subparts B and C of the regulation; therefore, the notice-of-nonpayment, same-day settlement, and (current) expeditious-return requirements do not apply to checks drawn on the U.S. Treasury or U.S. Postal Service money orders.[98] Proposed § 229.34(f)(2) is consistent proposed § 229.34(e) and current § 229.34(a), providing that returned check warranties are not made with respect to checks drawn on the Treasury of the United States or U.S. Postal Service money orders.

Under Alternative 2, proposed § 229.34(f) would be reserved, because Alternative 2 does not include provisions relating to notice of nonpayment.

11. Section 229.34(g) – Truncating bank indemnity

Proposed § 229.34(g) would incorporate a new indemnity to be provided by a depositary bank that accepts a deposit of an electronic check related to an original check. If such a bank does not receive the original check, receives settlement or other consideration for an electronic check or substitute check related to the original check,

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[98] *See* current commentary to the definition of "paying bank" in current § 229.2(z). *See also* current § 229.42.

and does not receive the check returned unpaid, then that bank must indemnify a depositary bank that accepts the original check for deposit for that depositary bank's losses due to the check having already been paid.

The Board's reasons for proposing this new indemnity are set forth in detail above in connection with the discussion on the framework for electronic checks and returned checks within the **Overview of the 2013 Proposal**. In brief, the Board believes that a depositary bank that receives the benefit of permitting its customers to use remote deposit capture should also internalize any risk or cost to other banks (specifically banks that accept original checks) that may result from that practice.

12. Section 229.34(h) – Damages for breach of warranties

Proposed § 229.34(h) sets forth without substantive change the provisions of current § 229.34(e) relating to damages for breach of the warranties set forth in the section.

13. Section 229.34(i) – Indemnity amounts

Proposed § 229.34(i) would specify the maximum amounts of the new indemnities in proposed §§ 229.34(b) and (g). Specifically, proposed § 229.34(i) would provide that the indemnity amount not exceed the sum of the amount of the loss, up to the amount of the settlement or other consideration received by the indemnifying bank, and interest and expenses (including costs and reasonable attorney's fees and other expenses of representation). In addition, proposed §229.34(i) would subject the indemnity to comparative negligence, i.e., the indemnity amount would be reduced by the portion of the indemnified bank's loss that is attributable to the indemnified bank's negligence or failure to act in good faith.

Furthermore, proposed § 229.34(i) would provide that the indemnity not reduce the rights of a person under the UCC or other applicable provision of state or federal law, including Regulation E.

Proposed § 229.34(i) is similar to the indemnity amount in current § 229.53(b)(1)(ii) of subpart D with respect to a substitute-check indemnity claim in the absence of a substitute-check warranty breach and the damages for breaches of warranties in § 229.34. The Board requests comment on whether losses proximately caused from not being able to make the warranty claim should be interpreted to cover damages awarded for violations of Regulation E.

14. Section 229.34(j) – Tender of defense

Proposed § 229.34(j) would set forth, without change, the provisions of current§ 229.34(f) relating to tender of defense.

15. Section 229.34(k) – Notice of claim

Proposed § 229.34(j) would set forth, without change, the provisions of current§ 229.34(g) relating to notice of claim.

16. Section 229.35 – Indorsements

Current § 229.35(a) requires a bank (other than the paying bank) that handles a check to indorse the check in a manner that permits a person to interpret the indorsement in accordance with the indorsement standard set forth in appendix D to the regulation. Current Appendix D pertains to indorsements that banks apply to original checks and substitute checks.

In 2011, the Board proposed to amend Appendix D to require banks that transfer electronic collection items or electronic returns to other banks to apply their

indorsements electronically in accordance with ANS X9.100-187, unless the parties otherwise agree. The 2011 proposal would have amended the related commentary to provide that, if a depositary bank included an e-mail address or other electronic address in its indorsement for delivery of electronic returns, and had agreed to accept electronic returns from the paying bank or returning bank, the paying bank or returning bank could send electronic returns to such address. The 2011 proposal also would have clarified that if the reconverting bank (the bank that creates a substitute check) is a bank that rejected a check submitted for deposit, it must identify itself by applying its routing number to the back of the check and that, in this instance, the routing number would be for identification purposes only, and not an indorsement or acceptance.

Two commenters, including the group letter, generally supported the Board's proposed changes. One of these commenters supported using ANS X9.100-187 as the standard for applying indorsements electronically; the other stated that ANS X9.100-187 should merely be an example of a permissible agreed-upon standard. Five commenters, including the group letter, opposed the suggestion that a depositary bank might include an e-mail address or electronic address in its indorsement. One commenter supported the clarification that a bank that rejects a check submitted for deposit and creates a substitute check must identify itself as the reconverting bank on the back of the check.

The current proposal would eliminate Appendix D. The current proposal instead would incorporate the substance of the indorsement standards by referring to them into proposed § 229.35(a). Specifically, proposed § 229.35(a) would require a

bank (other than a paying bank) that handles a check during forward collection or a returned check to indorse the check in accordance with American National Standard Specifications for Check Indorsements, X9.100-111 (hereinafter ANS X9.100-111) for a paper check, ANS X9.100-140 for creating a substitute check, and ANS X9.100-187 for an electronic check or electronic returned check, unless the Board by rule or order determines that different standards apply or the parties otherwise agree. The current proposal would also delete substantial portions of the commentary to current § 229.35(a) discussing substantive aspects of indorsements, such as the location and content of banks' indorsements, because those specifics are set forth in the applicable industry standard (or by the agreement of the parties). Proposed § 229.35(d) would delete the reference to Appendix D in current § 229.35(d). The current proposal would not amend current §§ 229.35(b) or (c).

When the current indorsement standard in Appendix D became effective in 2004 (concurrently with the Check 21 Act), substitute checks were new and banks were in the early stages of establishing processes and systems to create, indorse, and handle them. Banks were also in the early stages of learning how to apply indorsements and bank identifications electronically, such that they could later be applied to any substitute check created. Since that time, however, banks' processes related to substitute checks and applying indorsements and identifications electronically have become well established. Further, industry standards now set forth the specifics for how banks should indorse, or identify themselves on, original checks and substitute checks they handle, substitute checks that they create, and electronic items they handle.

The proposed commentary to proposed § 229.35(a) commentary notes that ANS X9.100-187 is an industry standard for handling checks electronically, but that multiple electronic check standards may exist that would enable a receiving bank to create a substitute check, and that the parties may agree to send and receive checks as electronic images and information that conform to a different standard.

The proposed commentary to proposed § 229.35(a) would also remove the portions of the current commentary that discuss allocation of liability under § 229.38(d), because those matters are discussed in the proposed commentary to proposed § 229.38. Finally, the proposed commentary to proposed § 229.35(a) would move those portions of the commentary that discuss reconverting banks' obligations at the time they create a substitute check into the proposed commentary to § 229.51(b), which discusses reconverting-bank duties. For example, as proposed in 2011, the proposed § 229.51(b) commentary notes that if the reconverting bank is a bank that rejected a check submitted for deposit, then its routing number (with asterisks) on the back of the check is for identification only, and is not an indorsement or acceptance.

The current proposal would make clarifying changes throughout the proposed commentary to proposed § 229.35. For example, in paragraph 5 in the proposed commentary to § 229.35(b), the Board is proposing to clarify the regulation's use of the term "final settlement."

17. Section 229.36 – Presentment and issuance of checks

The current proposal would amend current §§ 229.36(a), (b) and (f) and would eliminate current § 229.36(e).

a. Section 229.36(a) – Receipt of electronic checks

Proposed § 229.36(a) would provide that a paying bank's receipt of an electronic check is governed by the paying bank's agreement with the presenting bank. The proposed commentary to proposed § 229.36(a) would state that the terms of the agreement are determined by the parties and may include, for example, the electronic address or electronic receipt point at which the paying bank agrees to accept electronic checks, as well as when presentment occurs. The Board does not believe that banks' existing practices for electronic check presentment need be changed as a result of the Board's proposal.

b. Section 229.36(b) – Receipt of paper checks

The current proposal would amend current § 229.36(b) and its commentary to make changes that are substantively identical to those set forth in the 2011 proposal. The Board received no comments in response to the changes in the 2011 proposal that are set forth in proposed § 229.36(b)(1) regarding the locations at which a check in paper form is considered received by the paying bank. The Board also is proposing to amend the commentary to delete the statement about the tradeoff between including an address on a check, versus simply stating the name of the bank to encourage wider currency of the check, because the physical location of a bank no longer limits the acceptance of its checks.

Proposed § 229.36(b)(2) would permit a paying bank to require that forward-collection checks be separated from returned checks, a provision that is not in the current regulation but that was included in the 2011 proposal. Two commenters supported that aspect of the 2011 proposal. One Reserve Bank commenter opposed

it, stating that it benefits a paying bank that requires presentment of paper checks in a way that contradicts the broader intent of the proposal to encourage banks to send and receive checks electronically. Proposed § 229.36(b)(2) accordingly would permit a depositary bank to require that returned checks be separated from forward-collection checks. A paying bank that has agreed to accept electronic presentment might nonetheless receive presentment in paper form (see proposed § 229.36(d)), and having the ability to require that paper forward-collection checks be separated from paper returned checks may benefit the paying bank in such cases. The Board requests comment on whether paying banks should be permitted to require that forward-collection checks be separated from returned checks, and consequently, whether depositary banks should continue to be permitted to require that forward-collection checks be separated from returned checks.

c. Section 229.36(d) – Same-day settlement

For the reasons discussed above in the **Overview of the 2013 Proposal**, the Board proposes to retain, without substantive change, the current same-day settlement provisions. The Board proposes to clarify throughout proposed § 229.36(d) (current § 229.36(f)) that the same-day settlement provisions apply only to presentments of checks in paper form. As described above under proposed § 229.36(a), electronic check presentment is governed by the paying bank's agreement with the presenting bank.

Proposed § 229.36(d)(1), like the 2011 proposal, would remove the requirement in that a paying bank accept presentment for same-day settlement at a location that is in the check-processing region consistent with the routing number on

the check, because there is only one check-processing region and there are no longer any checks considered nonlocal. The Board received no comments on this aspect of the 2011 proposal.

Proposed § 229.36(d)(2) would set forth the provisions of current § 229.36(f)(2) permitting a paying bank to require that checks presented for same-day settlement be separated from other forward-collection checks or returned checks. The 2011 proposal would have deleted this provision and eight commenters, including the group letter, objected to its removal. No commenters supported removing the provision. The Board believes that retaining the provisions of proposed § 229.36(d)(2) is consistent with the proposal to retain § 229.36(b)(2), which permits paying banks more generally to require that forward-collection checks be separated from returned checks.

d. Current § 229.36(e) – Issuance of payable-through checks

The 2011 proposal would have deleted current § 229.36(e) as unnecessary because there is now a single national check-processing region.[99] The Board received no comments on this portion of the 2011 proposal, and the current proposal would also delete current § 229.36(e) and reserve the paragraph.

18. Section 229.37 – Variation by agreement

Current § 229.37 permits parties to vary by agreement the effect of the provisions in subpart C, and the current commentary to § 229.37(a) provides examples of situations where variation by agreement is permissible. In general, the

[99] The purpose of § 229.36(e) was to alert the depositary bank that it could not rely on the routing number in the MICR line of the check for purposes of determining whether the check was local or nonlocal.

Board is proposing to revise the commentary to conform to the provisions of the current proposal (for example, by referring to agreements varying the notice-of-nonpayment timeframes in Alternative 1, rather than the timeframes for return of checks).[100]

In 2011, the Board proposed to revise its examples in the commentary to § 229.37(a) related to returning and presenting checks electronically in order to conform the examples to the 2011 proposal. The Board also proposed removing current comment C.7 related to acceptance of checks presented for same-day settlement at a location that is not in the same check-processing region as the routing number on the checks. (*See* discussion in connection with proposed § 229.36(d)(1)). The two commenters that addressed the proposed revisions to the examples, including the group letter, both supported them, and the Board's revised proposal includes them with non-substantive changes. The Board also proposes to add, as an example of permissible variation by agreement. that a depositary bank or returning bank may agree with another returning bank or paying bank to set a cutoff hour earlier than 2:00 p.m. for receipt of returned checks.

Two commenters, including the group letter, requested the Board include an example providing that it would be permissible for banks to agree to vary the warranties in proposed § 229.34(a). One commenter broadly opposed that approach because it could result in the risk allocation under the proposed warranties not applying if collecting and presenting banks agree to accept items not meeting the

[100] The Board proposes these changes in proposed paragraphs A and C.5 in the commentary to § 229.37. Alternative 2 would continue to refer to the timeframes for expeditious return instead of notice of nonpayment.

definition of an electronic collection item or electronic return, which would create uncertainty. As mentioned above, the proposed commentary to proposed § 229.34(a) that a sending bank and receiving bank may vary by agreement the warranties the sending bank makes to the receiving bank for electronic images of or electronic information related to checks, for example, to provide that the bank transferring the check does not warrant that the electronic image or information are sufficient for creating a substitute check. Such variation by agreement, however, would not extend to banks, drawers, and owners that are not bound by the agreement.

The Board believes that the current proposal's provisions that would broaden the definitions of "electronic check" and "electronic returned checks" removes the uncertainty as to whether the proposed risk-allocation framework will apply to a given electronic item. Through its agreement with the sending bank, a receiving bank should be able to determine whether the Board's proposed warranties apply to an item.

One commenter on the 2011 proposal expressed concern with a practice related to electronic presentment agreements. This commenter believed that several banks have agreed to a practice described as follows: The depositary bank and the paying bank agree (either directly or through clearinghouse rules) to send electronic information related to a check prior to sending the accompanying electronic image of the check. Under the agreement, presentment would require receipt of both the electronic information and the electronic image. The paying bank debits its

customer's account based on receiving the electronic information.[101] Further, the commenter stated that the depositary bank and the paying bank agree to split between them the credit float that is generated by debiting the paying bank's customer before the depositary bank's customer is credited.[102] The commenter stated that the paying bank then places a portion of its customer's funds in a suspense account on its books for the benefit of the depositary bank. Then, once the electronic image of the check is sent to the paying bank, the paying bank credits the remaining amount of the check to the depositary bank. The commenter requested that the Board amend the regulation to provide that such a practice would be an impermissible variation by agreement of the effect of the provisions of subpart C of the regulation.

With respect to the amount of interest accrued by the depositary bank's customer, the practice described by the commenter appears to be governed by § 229.14(a) of subpart B of the regulation, which requires a depositary bank to begin to accrue interest or dividends on funds deposited in an interest-bearing account not later than the business day on which the depositary bank receives credit for the funds.[103]

The Board requests comment on the extent to which, and the specifics of how, banks may be engaging in this practice. The Board also requests comment on

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[101] The commenter noted that the paying bank's customer's account was debited for a check at least one business day prior to the day on which the depositary bank's customer's account is credited for the check. Subpart B, which is not subject to this proposal, governs the timeframes within which depositary banks must credit its customer's account for deposited checks. Those timeframes are not linked to the timing of the debit to the drawer's account.

[102] The credit float is generated because the banks have the benefit of the deposited funds overnight between those two days.

[103] The commentary to that section explains that a depositary bank that receives a bookkeeping entry that does not represent funds actually available for the depositary bank's use is not credit for purposes of § 229.14(a).

whether and how banks have modified their account agreements with their customers to address such a practice. Finally, the Board requests comment on whether it should consider the practice to be an impermissible variation by agreement of the provisions of subpart C of the regulation.

19. Section 229.38 – Liability

a. § 229.38(a) – Standard of care, liability, damages

Proposed § 229.38(a) sets forth the provisions of current § 229.38(a) under Alternative 1. Proposed § 229.38(a) under Alternative 2 is the same as under under Alternative 1, except that the reference to notice of nonpayment is deleted.

b. Current § 229.38(b) – Paying bank's failure to make timely return

Alternative 1. Proposed Alternative 1 would remove current § 229.38(b) and its accompanying commentary. Current § 229.38(b) provides that a paying bank that fails to comply with both the expeditious-return requirement and its return deadline under the UCC, Regulation J, or current § 229.30(c) will be liable for one or the other but not both. The Board believes this liability provision is no longer necessary under Alternative 1 because Alternative 1 does not contain an expeditious-return requirement, so that a paying bank will be required to comply only with its return deadline under the UCC (or as extended under current § 229.30(c) or proposed § 229.31(g)). The Board requests comment on whether it is necessary to retain this provision absent an expeditious-return requirement.

Alternative 2. The Board is proposing to retain an expeditious-return requirement under Alternative 2. Therefore, under Alternative 2, the Board would retain current § 229.38(b).

c. Proposed § 229.38(c) – Comparative negligence

The proposed commentary to proposed § 229.38(c) would revise the examples in the commentary to current § 229.38(c) to discuss the comparative-negligence provision in the context of delay in delivering a notice of nonpayment, as opposed to delay in delivering a returned check. Under Alternative 2, the current examples in the commentary would be retained because Alternative 2 retains the expeditious-return requirement.

d. Section 229.38(d) – Responsibility for certain aspects of checks

Proposed § 229.38(d) would address banks' responsibilities for certain aspects of checks. A paying bank is responsible for damages resulting from an illegible indorsement to the extent that the condition of the check when issued by the paying bank or its customer adversely affected the ability of a bank to indorse the check legibly in accordance with § 229.35. By contrast, the depositary bank is liable to the extent the condition of the back of a check arising after issuance and prior to acceptance of the check by the depositary bank adversely affects the ability of a bank to indorse the check legibly in accordance with § 229.35. The current commentary provides examples of these liabilities with multiple references to the indorsement standard in Appendix D. In accordance with the proposed changes to § 229.35 (and the proposed elimination of appendix D), the Board proposes to replace the references to Appendix D with a specific reference to the appropriate industry standard. In addition, the Board proposes to move the substance of paragraphs 12 and 13 in the current commentary to § 229.35(a) to a new paragraph in the proposed commentary to proposed § 229.38(d), and clarify the liability framework when indorsements are

unreadable due to markings on the check at issuance, for example, to carbon bands on the checks.[104] The Board requests comment on whether its proposed revisions clarify liability for unreadable indorsements, as well as whether any checks still bear carbon bands.

Current § 229.38(d)(2) makes drawee banks liable to the extent they issue payable-through checks that are payable through a bank located in a different check-processing region and that circumstance causes a delay in return. The 2011 proposal would have deleted this liability provision and its commentary as obsolete, because there is now only one check-processing region. The Board received no comments on that aspect of its proposal, and the current proposal similarly would delete current § 229.38(d)(2).

The current proposal would make no changes to current §§ 229.38(e), (f), (g) and (h).

20. Section 229.39 – Insolvency of bank

Current § 229.39 addresses what happens when a paying bank, collecting bank, returning bank, or depositary bank suspends payments when a check is in the process of being collected or returned. Current § 229.39(a) requires a receiver, trustee, or agent in charge of a closed bank to return a check to the transferor bank or customer that transferred the check if the check or returned check (1) is in, or comes into, the possession of the paying bank, collecting bank, depositary bank, or returning

[104] The current commentary to § 229.35(a) states that the indorsement standard does not prohibit the use of a carbon band or other printed or written matter on the backs of checks and does not require banks to avoid placing their indorsements in these areas. Nevertheless, checks will be handled more efficiently if depositary banks design indorsement stamps so that the nine-digit routing number avoids the carbon band area.

bank that suspends payment and (2) is not paid. This provision is similar to UCC § 4-216(a).

Current §§ 229.39(b) and (c) provide banks with "preferred" claims against a paying bank, collecting bank, returning bank, or depositary bank with respect to checks or returned checks that are not returned by the receiver, trustee, or agent in charge of a closed bank under § 229.39(a). In current § 229.39(b), a bank that is prior to the paying bank in the collection chain has a claim against a paying bank that has finally paid the check, but suspends payment without making a settlement for the check that is or becomes final. Similarly, a bank that is prior to the depositary bank in the return chain has a claim against a depositary bank that has become obligated to pay the returned check. Current § 229.39(c) provides claims to banks in the collection or return chain that have not received settlement that is or becomes final from a collecting bank, paying bank, or returning bank that itself had received final settlement prior to suspending payments. These sections are derived from UCC § 4-216(b).

Although both Regulation CC and the UCC use the term "preferred claim," the Official Comment to the UCC provides that purpose of UCC § 4-216 "is not to confer upon banks, holders of items, or anyone else preferential positions in the event of bank failures over general depositors or any other creditors of the failed banks." Rather, UCC § 4-216 is intended to fix the cut-off point at which an item has progressed far enough in the collection or return process where it is preferable to

permit the item to continue the remaining collection or return process, rather than return the item and reverse the associated entries.[105]

Proposed § 229.39(b) would set forth amended provisions from current §§ 229.39(b) and (c) intended to clarify that the claims do not give a bank a preferential position over depositors or other creditors of the failed banks. The Board does not intend these changes to be substantive.

Proposed § 229.39(c), like current § 229.39(c), would provide a paying bank with a preferred claim against a presenting bank that breaches a settlement amount or encoding warranties in § 229.34. The Board intended that the claim in current § 229.39(d), set forth in proposed § 229.39(c), be a preferred claim, putting the paying bank in the position of a secured creditor.[106] The Board requests comment on whether the Board should continue to provide a preferred claim against the presenting bank for breach of the settlement amount and encoding warranties or whether it should provide only a claim, but not a preferred claim.

21. Section 229.40 – Effect of merger transaction

The current proposal retains the provisions of the 2011 proposal that would delete as obsolete the provision in § 229.40(b) regarding mergers consummated on or after July 1, 1998, and before March 1, 2000. The Board received no comments on this aspect of the 2011 proposal.

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[105] UCC § 4-216, cmt. 1.

[106] 57 FR 46596 (Oct. 14, 1992). The Board, however, did not intend this to be a "preference" under the Bankruptcy Code (i.e., an avoidable transfer).

22. Section 229.43 – Checks payable in Guam, American Samoa, and the Northern Mariana Islands

The current proposal, like the 2011 proposal, would modify § 229.43 to reflect how the proposed warranties and indemnities in § 229.34 would apply to checks payable in Guam, American Samoa, and the Northern Mariana Islands (Pacific island checks). For example, a bank that handles a Pacific island check in the same manner as other checks may transfer an electronic image of or electronic information related to a Pacific island check and would make the proposed warranties and indemnities in proposed §§ 229.34(a), (b), and (g) with respect to the items. The Board received no comments on this aspect of the 2011 proposal.

The current proposal would also amend the commentary proposed § 229.43 to state that bank offices in Guam, American Samoa, and the Northern Mariana Islands are banks for purposes of subpart D (but not subparts B or C) of the regulation, because the Check 21 Act uses a broader definition of state than does the EFA Act.

F. Subpart D—Substitute Checks

23. Section 229.51 – General provisions governing substitute checks

The current proposal would remove all references to Appendix D in § 229.51 and replace them with references to the specific industry standard in the text of proposed § 229.51, where applicable. As discussed in connection with proposed § 229.35, the current proposal would move the portions of the commentary to current § 229.35(a) that address indorsement standards for reconverting banks and substitute checks to the commentary to § 229.51(b). In doing so, the Board intends no substantive change.

24. Section 229.52 – Substitute check warranties

For the reasons set forth in its 2011 proposal, thecurrent proposal would provide that a bank that rejects a check submitted for deposit and sends back to its customer a substitute check (or a paper or electronic representation of a substitute check) would make the warranties in § 229.52(a) regardless of whether the bank received consideration for the substitute check.[107] If a bank makes those warranties, the substitute check provided to the customer would be the legal equivalent of the original check that the bank rejected for deposit, provided that the substitute check meets the requirements for legal equivalence set forth in § 229.51(a). If the substitute check did not meet the requirements for legal equivalence, then the substitute check recipient would have a Check 21 warranty claim against the bank.

Because the bank is both the truncating bank and the reconverting bank with respect to the check, the bank must identify itself on the front of the substitute check as the truncating bank and on the front and back of the check as the reconverting bank, in accordance with the terms of § 229.51(b). The bank is not, however, a depositary bank, collecting bank, or returning bank with respect to the check. Moreover, the bank's identification of itself on the back of the check as a reconverting bank does not constitute the bank's indorsement of the check. To address this point, the current proposal, like the 2011 proposal, would amend the commentary to § 229.51(b).

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[107] *See* 76 FR 16862, 16882-83 (Mar. 25, 2011). Two commenters, including the group letter, supported the Board's March 2011 proposal. None opposed.

The proposed commentary to proposed § 229.52 would also provide that a bank that is a truncating bank under § 229.2(eee)(2) because it accepts deposit of a check electronically might be subject to a claim by another depositary bank that accepts the original check for deposit, pursuant to proposed § 229.34(g).

25. Section 229.53 – Substitute check indemnity

The current proposal, like the 2011 proposal, would provide that a bank that rejects a check submitted for deposit and sends back to its customer a substitute check provide the indemnity set forth in § 229.53(a), regardless of whether the bank received consideration. The proposed commentary would also provice that a bank that transfers and receives consideration for an electronic check or electronic returned check that is an electronic representation of a substitute check is responsible for providing the indemnity in § 229.53.

IV. Other Requests for Comment

A. Effective date

Most commenters responding to the 2011 proposal generally supported the Board's proposed six-month delayed effective date for the portions of the proposal related to subpart C of the regulation.[108] A few commenters requested a twelve-month delayed effective date, emphasizing in particular that the effective date of the proposed deletion of the notice of nonpayment provision should be so delayed. One of the commenters expressing opposition to the proposed new exception to the

[108] Some of these commenters conditioned their support for the six-month delayed effective date on needing more time – *e.g.*, 24 months – to deal with the then-proposed (1) elimination of the "refer to maker" reason for return; and (2) references to possible inclusion of e-mail addresses in depositary-bank indorsement records. This proposal permits "refer to maker" to be used in certain cases, such as when a drawer with a positive pay arrangement instructs the paying bank to return the check. This proposal does not refer to inclusion of email addresses in indorsements.

expeditious-return requirement (that the requirement not apply if the depositary bank had not agreed to accept an electronic return), however, stated that 18 months between publication of the rule and its effective date would give banks adequate time to make the operational changes necessary to receive returns electronically so as to continue to receive the returns expeditiously.

Under both Alternative 1 and Alternative 2, as under the 2011 proposal, depositary banks would not be required to receive returned checks electronically. Instead, a depositary bank that agrees to receive returns electronically would receive checks more quickly. This approach, like the approach taken in the 2011 proposal, is intended to allow each depositary bank that continues to require paper returned checks to make the decision, based on its own internal cost-benefit analysis, as to when the risk and cost associated with receiving paper returned checks in a "non-expeditious" fashion begins to outweigh the continually declining cost of transitioning to receive returns electronically, such that it would then make business sense for that depositary bank to begin to receive returns electronically.[109]

Therefore, the Board proposes that the proposed amendments to subparts A, C and D would become effective six months following publication of a final rule. With respect to Alternative 1 (which would impose a notice-of-nonpayment requirement on all checks returned as paper), the Board requests comment on whether six months is sufficient time for a paying bank to adjust its operations to accommodate sending notices of nonpayment for checks under $2,500.

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[109] Under Alternative 1, however, the depositary bank would receive notice of nonpayment within a two-day timeframe if the paying bank sends a paper returned check.

B. Definition of remotely created check

1. Checks created by payee

Regulation CC sets forth transfer and presentment warranties related to "remotely created checks." Current § 229.2(fff) defines a remotely created check as a check that is not created by the paying bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn. The warranty in current § 229.34(d) (set forth in proposed § 229.34(c)) shifts liability for unauthorized remotely created checks to the depositary bank, which is generally the bank for the person that initially created and deposited the remotely created check.

Although the Board's 2011 proposal did not raise the issue, several commenters, including the group letter, suggested that the Board consider a revised definition of "remotely created check" that distinguishes between those checks created by the payee (or payee's agent) and those checks created by a third party (e.g., bill payment service) on behalf of the person on whose account the check is drawn.[110] Specifically, these commenters suggested that only checks created by the payee or payee's agent be considered remotely created checks, instead of all checks that are not created by the paying bank. These commenters believed that checks created by a third party on behalf of the paying bank's customers raise different policy or operational issues as those checks created by the payee or the payee's agent and, thus, should be excluded from the definition of "remotely created checks." Commenters

[110] For example, a consumer may use a third-party bill payment provider to make a payment to a biller (e.g., a utility company). The provider, in turn, may pay create a check to pay the biller. The biller then deposits the check with its bank.

noted that in these types of situations, the depositary bank and its customer (the payee) do not have a contractual relationship with the entity that created the remotely created check, and that it is therefore difficult for the bank and its customer to provide evidence, in response to a warranty claim, that the check was authorized by the payor.

The current proposal would narrow the range of items that come within the definition of "remotely created check." When the Board amended Regulation CC in 2006 to add the definition of "remotely created check" (as well as the related warranties), the Board declined to adopt its proposed definition, which was essentially identical to what commenters now suggest.[111] Commenters on the 2011 proposal stated that the definition proposed in 2005 was too narrow and should be revised to encompass checks not created by the paying bank.[112] In 2006, the Board determined to apply the warranty to checks that are not created by the paying bank so that the paying bank would be able to determine to which checks the warranty applied. The Board noted that its definition covered certain checks created remotely by bill-payment services (as well as checks that the drawer created but neglected to sign) where there is a less compelling reason for shifting liability for unauthorized checks to the payee's bank. At that time, however, the Board believed that including these checks would be unlikely to result in significantly greater liability for depositary

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[111] In 2005, the Board proposed to define "remotely created check" to mean a check that is drawn on a customer account at a bank, *is created by the payee*, and does not bear a signature in the format agreed to by the paying bank and the customer" (emphasis added). .*See* 70 FR 10509, 10513 (Mar. 4, 2005).

[112] The supplementary information of the **Federal Register** notice announcing the Board's final rule discussed this aspect of the "remotely created check" definition in greater detail. *See* 70 FR 71218, 71221-71222 (Nov. 28, 2005).

banks as such checks were generally less prone to fraud, and, therefore, less prone to trigger a warranty claim than payee-created checks.

The Board currently requests comment on whether it should narrow the scope of the definition to include only checks created by the payee (or payee's agent), as opposed to the current definition's scope of checks "not created by the paying bank." As a general matter, such a change would reduce the portion of checks with respect to which paying banks could make an unauthorized-check warranty claim against the depositary bank. The Board requests comment on the extent to which banks, in their role as depositary banks, are receiving remotely-created-check warranty claims related to checks that were not created by the depositary banks' customers or their agents. The Board also requests comment on the extent to which banks, in their role as paying banks, may be inadvertently making warranty claims for items the banks believe to be "remotely created checks," but that were actually created by the paying bank, or its agent, such as through the bank's Internet-banking platform. Finally, the Board requests comment on what warranties should apply to checks created by neither the payee (or payee's agent) nor the paying bank were the Board to adopt a more limited definition of "remotely created check" as the commenters suggest.

2. Form of signature

The Board has recently received a comment raising a concern that the spread of technology makes it more likely that the creator of an RCC (or an eRCC) could apply a "signature" to the item that was obtained electronically from the drawer and resembles the drawer's handwritten signature. The commenter was concerned that such an item might fall outside the definition of RCC because it bears a signature that

is purported to be applied by the drawer. The Board requests comment on whether such items are currently being created and whether the Board should revise the definition of RCC to include items bearing such "signatures." The Board also requests comment on how these "signatures" could be distinguished from more traditional "pen-and-ink" drawer's signatures, for which paying banks do *not* have a warranty claim on prior collecting banks under Regulation CC.

C. Presumption of alteration

Under the UCC, an alteration is a change to the terms of a check that is made after the check is issued and that modifies an obligation of a party, for example, changing the payee's name or the amount of the check.[113] By contrast, a forged, or counterfeit, check is a check on which the signature of the drawer (i.e., the actual customer of the paying bank) was forged at the time of the check's issuance. In general, under the UCC as enacted in a given state, the paying bank may charge the drawer's account only for checks that are properly payable. (UCC § 4-401.) Neither altered checks nor forged checks are properly payable. In the case of an altered check under the UCC, however, the banks, including the paying bank, have warranty claims against the banks that transferred the check (e.g., a collecting bank or the depositary bank). In the case of a forged check, however, the UCC typically does not provide the banks, including the paying bank, with warranty claims against banks that transferred

[113] UCC § 3-407.

the forged check.[114] Therefore, the depositary bank typically bears the loss related to an altered check, whereas the paying bank bears the loss related to a forged check.

These provisions of the UCC reflect the rule set forth in Price v. Neal that the paying bank must bear the loss when a check it pays is not properly payable by virtue of the fact that the drawer did not authorize the item.[115] The Price v. Neal rule reflects the policy that the paying bank, rather than the depositary bank, is in the best position to judge whether the drawer's signature on a check is the authorized signature of its customer. By contrast, the depositary bank is arguably in a better position than the paying bank to inspect the check at the time of deposit and detect an alteration to the face of the check, or determine that the amount of the check is unusual for the depositary bank's customer.

In 2006, two United States Courts of Appeals, the Fourth Circuit and the Seventh Circuit, addressed the issue of evidentiary burden related to proving whether a check was altered or forged (or counterfeit).[116] These two courts reached opposite conclusions as to whether a paid, but fraudulent, check should be presumed to be altered or counterfeit in the absence of evidence (such as the original check). In each of the cases, Wachovia Bank was the paying bank with respect to a fraudulent check of more than $100,000, litigating with the depositary bank about which bank should bear the loss represented by the check. In both cases, the drawer issued a check in the

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[114] The presenting bank warrants to the paying bank only that it has no knowledge of an unauthorized drawer's signature. *See* UCC §§ 3-417 and 4-208.

[115] *Price v. Neal*, 97 Eng. Rep. 871 (K.B. 1762).

[116] The two court cases are *Chevy Chase Bank v. Wachovia Bank, N.A.*, 208 Fed. App'x. 232, 235 (4th Cir. 2006) ("Chevy Chase") and *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, 457 F.3d 619 (7th Cir. 2006) ("Foster").

amount at issue, but the name of the payee on the check was different from that on the check as issued. After paying the check, Wachovia then destroyed the check in the ordinary course of business. At issue in both cases was whether the changed payee name on the deposited check had resulted from an alteration of the original check that the drawer issued – in which case the depositary bank would bear the loss – or from the creation of a new, counterfeit check identical to the original check in all respects except that the payee name had been changed – in which case the paying bank would bear the loss.

In each case, the evidence presented regarding the disputed check was insufficient to determine whether that check was altered or a forgery. In *Foster*, the Fourth Circuit determined that alteration should be presumed, because changing the payee's name was a "classic" alteration and there was no evidence that duplicating an entire check was a common method of changing the payee's name. Wachovia (the paying bank) prevailed, and the depositary bank bore the loss.[117] In C*hevy Chase*, the Seventh Circuit determined that Wachovia failed to present any evidence that the check had been altered, and Wachovia (the paying bank) bore the loss.[118]

Although the Board's proposal did not raise the issue, two commenters requested that the Board address the uncertainty that results from these divergent appellate court decisions by incorporating into the regulation a "presumption of alteration" that would apply when a fraudulent item is presented to the paying bank electronically or as a substitute check and the paying bank pays the item.

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[117] *Foster*, 457 F.3d at 622-23.

[118] *Chevy Chase*, 208 Fed. Appx. at 235.

Specifically, the commenter requested that the Board adopt the approach taken in Fourth Circuit in *Foster* and presume alteration, such that the depositary bank would bear the loss.[119] The commenter noted that the current UCC loss-allocation framework set forth above was established when, in most cases, original checks were presented to paying banks for payment (or were delivered to the paying bank subsequent to presentment of an electronic image or information), and these checks were retained by the paying bank or its customer such that, if necessary, the check could be examined to determine whether the original check had been altered or an entirely counterfeit check, with a changed payee name, had been created. One commenter stated that in the current check-processing environment, ushered in by Check 21 (in which the paying bank no longer has the right to demand presentment of the original check), it is likely to be the depositary bank or its customer that truncates the original check. This commenter believed that the depositary bank therefore should balance the cost of retaining the original check in certain situations (e.g., a check of large dollar amount), so as to be able to overcome, if necessary, a presumption of alteration suggested.

The Board believes that the substance of the UCC's loss-allocation framework for altered and forged checks, under which the depositary bank generally bears the loss for altered checks and the paying bank generally bears the loss for forged checks, continues to be appropriate in the current check-processing environment. With respect to the evidentiary presumption, the Board requests comment on whether it

[119] Under § 611(f) of the EFA Act (12 USC § 4010(f)), the Board is authorized to impose on or allocate among depository institutions the risks of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks.

should adopt an evidentiary presumption in Regulation CC as to whether, in cases of doubt, a check should be presumed to be altered or forged, and, if yes, whether the presumption should be of alteration or of forgery. In particular, the Board requests comment on whether banks are aware of or have information pertaining to whether counterfeit checks are a more common method of committing fraud than altering the payee name or amount on the check. The Board is aware that the Electronic Check Clearing House Organization has incorporated a presumption of alteration into its rules and requests comment on banks' experience with the presumption to date.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the proposed rulemaking under the authority delegated to the Board by the Office of Management and Budget (OMB). The collection of information that is proposed by this rulemaking is found in 12 CFR 229. The Board may not conduct or sponsor, and an organization is not required to respond to, an information collection unless it displays a currently valid OMB control number. The OMB control number for current information collections under Regulation CC is 7100–0235. In addition, as permitted by the PRA, the Board extends for three years the current disclosure requirements in connection with Regulation CC.

The EFA Act and the Check 21 Act authorize the Board to issue regulations to carry out the provisions of those Acts (12 U.S.C. § 4008 and 12 U.S.C. 5014, respectively). The Board has implemented the EFA Act and the Check 21 Act in Regulation CC.

Regulation CC applies to all banks, not just state member banks. However, under the PRA, the Board accounts for the burden of the paperwork associated with the regulation only for entities that are supervised by the Federal Reserve: state member banks and uninsured state branches and agencies of foreign banks. Other federal financial agencies are responsible for estimating and reporting to OMB the total paperwork burden for the institutions for which they have administrative enforcement authority. Under the current requirements, the annual burden to comply with the notice-of-nonpayment requirement in Regulation CC is estimated to be 3,592 hours for the 1,025 institutions supervised by the Federal Reserve and that are deemed to be respondents for the purposes of the PRA.

As discussed above, the Board proposes two alternatives to the check-return requirements, including two alternatives to the notice-of-nonpayment requirement imposed on paying banks that determine not to pay checks. Under Alternative 1, a paying bank would be subject to the notice-of-nonpayment requirement only if the paying bank sends the returned check in paper form. Unlike the current rule, Alternative 1's notice-of-nonpayment requirement would apply irrespective of the dollar value of the check being returned. Under Alternative 2, the Board proposes to eliminate the notice-of-nonpayment requirement. Finally, irrespective of which alternative the Board adopts, the Board would propose to require a depositary bank to notify its customer if the depositary bank receives a notice of recovery under § 229.35(b).

Under Alternative 1, the Board estimates that the proposed amendments to the notice-of-nonpayment requirement will decrease the number of notices that a paying

bank must send. Paying banks would no longer be required to provide notice of nonpayment for checks returned electronically, which the Board estimates to be 99.0 percent of checks returned. A paying bank would be subject to a new notice-of-nonpayment requirement for most of its paper returned checks in amount under $2,500. The Board, however, estimates that the size of the decrease in required notices due to paying banks sending electronic returned checks would outweigh the size of the increase in required notices due to imposing the requirement on paper returned checks irrespective of the dollar amount. Under Alternative 2, the notice-of-nonpayment requirement would be eliminated; therefore eliminating the paperwork burden associated with the requirement. Finally, the Board does not believe that explicitly stating that a depositary bank must notify its customer if the depositary bank receives notice of recovery under § 229.35(b) will significantly affect the burden. That requirement currently is set forth in the Board's Official Commentary to Regulation CC.

Under the current notice-of-nonpayment requirements, the Board estimates that the 1,025 respondents annually send 210 notices of nonpayment under current §§ 229.33(a) and (d). Under Alternative 1, the Board estimates that the notices of nonpayment sent by paying banks would be reduced. The annual burden for the notice-of-nonpayment information collection in Regulation CC is estimated to decrease from 3,592 to 2,396 hours. Under Alternative 2, the information collection burden attributable to the notice-of-nonpayment requirement would be eliminated.

As is currently the case, the proposed information collection would be mandatory. The Federal Reserve does not collect any of the proposed information,

and therefore no issue of confidentiality arises. If, however, during a compliance examination of a financial institution, a violation or possible violation of the EFA Act or the Check 21 Act is noted then information regarding such violation may be kept confidential pursuant to Section (b)(8) of the Freedom of Information Act. 5U.S.C. § 552(b)(8).

Comments are invited on: (1) whether the proposed collection of information is necessary for the proper performance of the Board's functions; including whether the information has practical utility; (2) the accuracy of the Board's estimate of the burden of the proposed information collection, including the cost of compliance; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.

You may submit comments by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/apps/foia/proposedregs.aspx.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include OMB number in the subject line of the message.
- FAX: (202) 452-3819 or (202) 452-3102.

- Mail: Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board's web site at http://www.federalreserve.gov/apps/foia/proposedregs.aspx as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

with copies of such comments sent to the Office of Management and Budget, Paperwork Reduction Project (7100–0235), Washington, DC 20503.

VI. Regulatory Flexibility Act

The Regulatory Flexibility Act (the ''RFA'') (5 U.S.C. 601 *et seq.*) requires agencies either to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. In accordance with section 3(a) of the RFA, the Board has reviewed the proposed regulation. In this case, the proposed rule would apply to all depository institutions. This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603 in order for the Board to solicit comment on the effect of the proposal on small entities. The Board will, if necessary, conduct a final regulatory flexibility analysis after consideration of comments received during the public comment period.

1. Statement of the Need for, Objectives of, and Legal Basis for, the Proposed Rule.

The Board is proposing the foregoing amendments to Regulation CC pursuant to its authority under the EFA Act and the Check 21 Act. The proposed rule is necessary to have Regulation CC reflect the substantial transition in the collection of checks from a largely paper-based process to one that is virtually all electronic. The proposed rule reflects the prevalent manner in which checks are now collected and returned. The full benefits and cost savings of the electronic check-processing methods facilitated by the Check 21 Act cannot be realized so long as some banks continue to employ paper-processing methods. The objective of the proposed rule is to encourage all banks to collect and return checks electronically.

2. Small Entities Affected by the Proposed Rule.

The proposed rule would apply to all depository institutions regardless of their size.[120] Pursuant to regulations issued by the Small Business Administration (13 CFR 121.201), a "small banking organization" includes a depository institution with $500 million or less in total assets. Based on call report data as of June 2013, there are approximately 12,164 depository institutions that have total domestic assets of $500 million or less and thus are considered small entities for purposes of the RFA. Based on December 2012 data regarding checks returned through the Reserve Banks, the Board estimates that 69 percent of small depository institutions had at that time made arrangements to receive returned checks electronically, whereas 31 percent had not.[121] Banks are steadily adopting electronic check handling methods, however, and the

[120] The proposed rule would not impose costs on any small entities other than depository institutions.

[121] In December 2010, 41 percent of small depository institutions had made arrangements to receive returns electronically, whereas 59 percent had not.

Board expects that a substantially higher percentage of small depository institutions will have made arrangements to receive electronic check returns by the time the a final rule becomes effective.

3. Projected Reporting, Recordkeeping, and Other Compliance Requirements.

By removing the regulation's expeditious-return requirement in Alternative 1 and conditioning the requirement on the ability of a returned check to be returned electronically in Alternative 2, the proposed rule would encourage, but not require, depositary banks to accept check returns in electronic form. A depositary bank that currently receives returned checks in paper form and that chooses, as encouraged by the proposal, to begin to receive returned checks electronically, will incur some cost associated with that transition. The Board continues to expect that these costs would be relatively low for a small depositary bank, which typically would receive only a small volume of returned checks. For example, as mentioned above, the Federal Reserve Banks offer a product under which they deliver electronically to small depositary banks copies (.pdf files) of returned checks, which the banks can print on their own premises if necessary.[122] To receive returned checks in this fashion, a depositary bank may need to establish and maintain an electronic connection to the Reserve Banks, or another returning bank that offers a similar service, and to purchase certain equipment, such as a printer capable of double-sided printing and magnetic-ink toner cartridges. Depending on the volume of returned checks that a small depositary bank receives, the Board continues to estimate that this transition

[122] After printing the .pdf files, the depositary bank would be able to process the checks exactly as it would process paper checks physically delivered to it.

would cost a small depositary bank approximately $5,000 in net-present-value terms.[123] A few commenters responding to the Board's March 2011 proposal stated that this $5,000 estimate of the cost to receive electronic returns is too low. Based upon its review of the comments, however, the Board believes that these commenters misinterpreted the $5,000 figure as being intended to cover costs associated with the portions of the March 2011 proposal that were related to subpart B of the regulation – for example, the proposed revisions related to the model funds-availability policy disclosures and provision of the hold notices. The $5,000 figure, however, represented an estimate of the net present value of only the cost to a small depositary bank to transition to receive returned checks electronically.

Conversely, a small depositary bank that does not choose to accept returned checks electronically would, under the proposal, incur additional risk associated with that decision. Specifically, a paper returned check may not be delivered to the bank in a timely fashion, which may result in the bank more frequently making funds available to its depositors before learning whether a check has been returned unpaid. Although this risk is difficult to quantify, it is reasonable to expect that each small depositary bank will weigh the costs and benefits of whether to accept returns electronically. If the bank determines that the net present value of the risk is greater than the cost to receive returned checks electronically, then the bank can minimize its

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[123] This estimate takes into account the cost to a small depositary bank to establish and maintain an electronic connection to the Reserve Banks, which is estimated to be $110 per month. *See* 78 FR 66715 (Nov. 6, 2013). This figure (i.e., the Reserve Banks' fee) is unchanged since the March 2011 proposal. Some small banks already have such a connection. Further, a small depositary bank may choose to receive its returns electronically in a manner that does not require this connection, such as through a different returning bank, an electronic check clearinghouse, or a nonbank processor.

cost associated with the Board's proposal by accepting returned checks electronically such that there is more likely to be an all-electronic return path from the paying bank.

The Board is proposing changes to the regulation's provisions that address depositary banks' handling of misrouted notices of nonpayment. Under the proposal, a depositary bank receiving a misrouted written electronic notice of nonpayment would be required to either promptly send the notice to the correct depositary bank directly or by means of a returning bank agreeing to handle it, or to send the notice back to the bank from which it was received. Currently, depositary banks are not required to take any action in response to a misrouted written electronic notice of nonpayment that they receive. The Board requests comment on any cost that may be imposed on small entities by this portion of its proposal.

Any costs to a small depositary bank that may result from the rule will be offset to some extent by savings to the bank in other areas. For example, receiving returned checks electronically may enable a small bank to reduce its ongoing operating costs associated with receiving and processing returned checks. Further, as other banks with which the small bank does business also begin to receive returned checks electronically, the small bank, in its role as paying bank, may experience lower costs associated with sending returned checks to other banks, because a paying bank typically pays a higher fee to a returning bank (or other service provider) to deliver a returned check in paper form to a depositary bank, as compared to delivering a returned check electronically to the depositary bank.

The regulation currently requires a paying bank that determines not to pay a check in the amount of $2,500 or more to provide notice of nonpayment such that the

notice is received by the depositary bank by 4:00 p.m. (local time) on the second business day following the banking day on which the check was presented to the paying bank. Return of the check itself satisfies the notice of nonpayment requirement if the return meets the timeframe requirement for the notice. Under the Board's proposed Alternative 1, a paying bank will only be required to provide notice if the bank initiates return of the related check in paper form, but the requirement would apply regardless of the dollar amount of the check. (Return of the check itself would continue to satisfy the notice requirement if the return meets the timeframe requirement for notice.) With respect to checks handled by the Reserve Banks, by the end of 2013, Reserve Banks estimate that paying banks will initiate check returns electronically 99.0 percent of the time, such that a notice would not be required with respect to those checks under the Board's proposal. The Board therefore expects that its proposal will substantially reduce the number of notices that paying banks send. In Alternative 2, the requirement to send a notice of nonpayment, as well as its associated costs, would be eliminated.

The Board proposes to require that the paying bank send a notice of nonpayment, if required under Alternative 1 or a returned check under Alternative 2 such that the notice or check reaches the depositary bank by 2:00 p.m. local time of the depositary bank, as opposed to the currently required 4:00 p.m. local time, on the second business day following the banking day of presentment. This earlier required time for receipt by the depositary bank may impose additional cost on the paying bank sending notice or returned check. However, any increased cost to a paying bank associated with delivering a notice or returned check by the earlier time may not be

material depending on a bank's current processing schedules, and it may be offset by reduced depositary bank losses associated with checks that are returned unpaid.

In connection with Alternative 1, any increase in a paying bank's cost associated with sending a notice under Alternative 1 should provide an increased incentive for a paying bank to send check returns electronically, thereby avoiding the requirement to send the notice. Over time, the proposal could reduce to zero the number of notices that paying banks send and eliminate entirely paying banks' costs associated with providing the notices.

The Board requests comment on the cost of its proposed rule to small depository institutions.

4. Identification of Duplicative, Overlapping, or Conflicting Federal Rules. The Board notes that subpart A of Regulation J overlaps with the proposed rule with respect to checks collected or returned through the Reserve Banks. The provisions of Regulation J supersede any inconsistent provisions of Regulation CC, but only to the extent of the inconsistency.[124]

5. Significant Alternatives to the Proposed Rule.

As discussed above in this **Federal Register** notice and in the 2011 proposal, the Board has extensively considered possible alternatives to Alternative 1 and Alternative 2 in this proposed rule. The Board believes that the other alternatives would either impose greater costs on small entities than would this proposed rule, or would be less preferable than this proposed rule for other reasons. For example, some of the other alternatives that the Board has considered might give undue preference in

[124] See 12 CFR 210.3(f).

the regulation to the Reserve Banks' returned-check services. Other possibilities might be disruptive to banks' existing processes for handling and routing returned checks.

List of Subjects in 12 CFR Part 229

Banks, Banking, Federal Reserve System, Reporting and recordkeeping requirements.

Authority and Issuance

For the reasons set forth in the preamble, the Board proposes to amend 12 CFR part 229 as follows:

PART 229—AVAILABILITY OF FUNDS AND COLLECTION OF CHECKS (REGULATION CC)

Subpart A—General

1. In § 229.1, paragraphs (b)(5) through paragraph (b)(10) are added as follows:

§ 229.1 Authority and purpose; organization

* * * * *

(b) *Organization*. This part is divided into subparts and appendices as follows—

* * * * *

(5) Appendix A of this part contains a routing number guide to next-day-availability checks. The guide lists the routing numbers of checks drawn on Federal Reserve Banks and Federal Home Loan Banks, and U.S. Treasury checks and Postal money orders that are subject to next-day availability.

(6) Appendix B of this part is reserved.

(7) Appendix C of this part contains model funds-availability policy

disclosures, clauses, and notices and a model disclosure and notices related to substitute-check policies.

(8) Appendix D of this part is reserved.

(9) Appendix E of this part contains Board interpretations, which are labeled "Commentary," of the provisions of this part. The Commentary provides background material to explain the Board's intent in adopting a particular part of the regulation and provides examples to aid in understanding how a particular requirement is to work. The Commentary is an official Board interpretation under section 611(e) of the EFA Act (12 U.S.C. 4010(e)).

(10) Appendix F of this part contains the Board's determinations of the EFA Act and Regulation CC's preemption of state laws that were in effect on September 1, 1989.

2. In § 229.2, paragraphs (dd), (vv) and (bbb) are revised and paragraph (ggg) is added. The revisions and addition read as follows:

§ 229.2 Definitions

* * * * *

(dd) Routing number means—

(1) The number printed on the face of a check in fractional form or in nine-digit form;

(2) The number in a bank's indorsement in fractional or nine-digit form; or

(3) For purposes of subpart C and subpart D, the bank-identification number contained in an electronic image of or electronic information related to a check.

(*ee) through (uu)* No change. * * * * *

(vv) Magnetic ink character recognition line and *MICR line* mean the numbers, which may include the routing number, account number, check number, check amount, and

other information, that are printed near the bottom of a check in magnetic ink in accordance with American National Standard Specifications for Placement and Location of MICR Printing, X9.13 (hereinafter ANS X9.13) for an original check and American National Standard Specifications for an Image Replacement Document—IRD, X9.100-140 (hereinafter ANS X9.100-140) for a substitute check, or, for purposes of subpart C and subpart D, contained in the electronic image of and electronic information related to the check in accordance with American National Standard Specifications for Electronic Exchange of Check Image Data – Domestic, X9.100-187 (hereinafter ANS X9.100-187) for an electronic image of and electronic information related to a check,unless the Board by rule or order determines that different standards apply.

(*xx) through (aaa)* No change * * *

(bbb) Copy and sufficient copy.

(1) A *copy* of a check means—

(i) Any paper reproduction of a check, including a paper printout of an electronic image of the check, a photocopy of the check, or a substitute check; or

(ii) Any electronic reproduction of a check that a recipient has agreed to receive from the sender instead of a paper reproduction.

(2) A *sufficient copy* means a copy of an original check that accurately represents all of the information on the front and back of the original check as of the time the original check was truncated or is otherwise sufficient to determine whether or not a claim is valid.

(*ccc*) through (*fff)* No change * * *

(ggg) Electronic check and electronic returned check. (1) Electronic check means an electronic image of a check or electronic information related to a check that–

(i) A bank or a nonbank depositor sends to a receiving bank pursuant to an agreement with the receiving bank, and

(ii) Conforms with ANS X9.100-187, unless the Board by rule or order determines that a different standard applies or the parties otherwise agree.

(2) *Electronic returned check* means an electronic image of a returned check or electronic information related to a returned check that–

(i) A bank sends to a receiving bank pursuant to an agreement with the receiving bank, and

(ii) Conforms with ANS X9.100-187, unless the Board by rule or order determines that a different standard applies or the parties otherwise agree.

Subpart C—Collection of Checks

3. Section 229.30 is revised to read as follows:

§ 229.30 Electronic images and electronic information

(a) Check under this subpart. Electronic checks and electronic returned checks are subject to this subpart as if they were checks or returned checks, unless otherwise provided in this subpart.

(b) Writings. If a bank is required to provide information in writing or in written form under this subpart, the bank may satisfy that requirement by providing the information in electronic form if the receiving bank has agreed to receive that information electronically from the sending bank.

4. Section 229.31 is revised to read as follows:

§ 229.31 Paying bank's responsibility for return of checks and notices of nonpayment.

Alternative 1 for paragraph (a)

(a) Return of checks. (1) A paying bank may send a returned check to the depositary bank, to any other bank agreeing to handle the returned check, or as provided under paragraph (2).

(2) A paying bank that is unable to identify the depositary bank with respect to a check may send the returned check to any bank that handled the check for forward collection and must advise the bank to which the check is sent that the paying bank is unable to identify the depositary bank.

(3) A paying bank may convert a check to a qualified returned check. A qualified returned check shall be encoded in magnetic ink with the routing number of the depositary bank, the amount of the returned check, and a "2" in the case of an original check (or a "5" in the case of a substitute check) in position 44 of the qualified return MICR line as a return identifier. A qualified returned original check shall be encoded in accordance with ANS X9.13, and a qualified returned substitute check shall be encoded in accordance with ANS X9.100–140.

(4) Except as provided in paragraph (g) of this section, this section does not affect a paying bank's responsibility to return a check within the deadlines required by the UCC or Regulation J (12 CFR part 210).

Alternative 2 for paragraph (a)

(a) *Return of checks.* (1) Subject to the requirement for expeditious return under paragraph (b), a paying bank may send a returned check to the depositary bank, to any other bank agreeing to handle the returned check, or as provided in paragraph (2).

(2) A paying bank that is unable to identify the depositary bank with respect to a check may send the returned check to any bank that handled the check for forward collection and must advise the bank to which the check is sent that the paying bank is unable to identify the depositary bank.

(3) A paying bank may convert a check to a qualified returned check. A qualified returned check shall be encoded in magnetic ink with the routing number of the depositary bank, the amount of the returned check, and a "2" in the case of an original check (or a "5" in the case of a substitute check) in position 44 of the qualified return MICR line as a return identifier. A qualified returned original check shall be encoded in accordance with ANS X9.13, and a qualified returned substitute check shall be encoded in accordance with ANS X9.100–140.

(4) Except as provided in paragraph (g) of this section, this section does not affect a paying bank's responsibility to return a check within the deadlines required by the UCC or Regulation J (12 CFR part 210).

Alternative 1 for paragraph (b)

(b) [Reserved.]

Alternative 2 for paragraph (b)

(b) *Expeditious return of checks.* (1) Except as provided in paragraph (c) of this section, if a paying bank determines not to pay a check, it shall return the check in an expeditious

manner such that the check would normally be received by the depositary bank not later than 2:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank.

(2) If the second business day following the banking day on which the check was presented to the paying bank is not a banking day for the depositary bank, the paying bank satisfies the expeditious return requirement if it sends the returned check in a manner such that the depositary bank would normally receive the returned check on or before the depositary bank's next banking day.

Alternative 1 for paragraph (c)

(c) [Reserved.]

Alternative 2 for paragraph (c)

(c) *Exceptions to the expeditious return of checks*. The expeditious return requirement of paragraph (b) of this section does not apply if—

(1) The paying bank does not have an agreement to send electronic returned checks to the depositary bank or to a returning bank that is subject to the expeditious return requirement for that check under § 229.32(b);

(2) The check is deposited in a depositary bank that is not subject to subpart B of this part; or

(3) A paying bank is unable to identify the depositary bank with respect to the check.

Alternative 1 for paragraph (d)

(d) *Notice of nonpayment*. (1) If a paying bank determines not to pay a check and sends the returned check in paper form, it shall provide notice of nonpayment such that the notice is received by the depositary bank by 2:00 p.m. (local time of the depositary bank)

on the second business day following the banking day on which the check was presented to the paying bank. If the day the paying bank is required to provide notice is not a banking day for the depositary bank, receipt of notice on the depositary bank's next banking day constitutes timely notice. Notice may be provided by any reasonable means, including the returned check, a writing (including a copy of the check), or telephone.

(2)(i) To the extent available to the paying bank, notice must include the information contained in the check's MICR line when the check is received by the paying bank, as well as—

(A) Name of the paying bank;

(B) Name of the payee(s);

(C) Amount;

(D) Date of the indorsement of the depositary bank;

(E) Account number of the customer(s) of the depositary bank;

(F) Branch name or number of the depositary bank from its indorsement;

(G) The bank name, routing number, and trace or sequence number associated with the indorsement of the depositary bank; and

(H) Reason for nonpayment.

(ii) If the paying bank is not sure of the accuracy of an item of information, it shall include the information required by this paragraph to the extent possible, and identify any item of information for which the bank is not sure of the accuracy.

(iii) The notice may include other information from the check that may be useful in identifying the check being returned and the customer.

(3) The requirements of this paragraph (d) do not apply if—

(i) The check is deposited in a depositary bank that is not subject to subpart B of this part; or

(ii) A paying bank is unable to identify the depositary bank with respect to the check.

Alternative 2 for paragraph (d)

(d) [Reserved.]

Alternative 1 for paragraph (e)

(e) *Identification of returned check.* A paying bank returning a check shall clearly indicate on the front of the check that it is a returned check and the reason for return. If the paying bank is returning a substitute check or an electronic returned check, the paying bank shall include this information such that the information would be retained on any subsequent substitute check.

Alternative 2 for paragraph (e)

(e) [Same as Alternative 1.]

Alternative 1 for paragraph (f)

(f) *Notice in lieu of return*. If a check is unavailable for return, the paying bank may send in its place a copy of the front and back of the returned check, or, if no such copy is available, a written notice of nonpayment containing the information specified in paragraph (d)(2). The copy or written notice shall clearly state that it constitutes a notice in lieu of return. A notice in lieu of return is considered a returned check subject to the requirements of this subpart.

Alternative 2 for paragraph (f)

(f) *Notice in lieu of return.* (1) If a check is unavailable for return, the paying bank may send in its place a copy of the front and back of the returned check, or, if no such copy is

available, a written notice of nonpayment containing the information specified in paragraph (f)(2).

(2)(i) To the extent available to the paying bank, notice must include the information contained in the check's MICR line when the check is received by the paying bank, as well as—

(A) Name of the paying bank;

(B) Name of the payee(s);

(C) Amount;

(D) Date of the indorsement of the depositary bank;

(E) Account number of the customer(s) of the depositary bank;

(F) Branch name or number of the depositary bank from its indorsement;

(G) The bank name, routing number, and trace or sequence number associated with the indorsement of the depositary bank; and

(H) Reason for nonpayment.

(ii) If the paying bank is not sure of the accuracy of an item of information, it shall include the information required by this paragraph to the extent possible, and identify any item of information for which the bank is not sure of the accuracy.

(iii) The notice may include other information from the check that may be useful in identifying the check being returned and the customer.

(3) The copy or written notice shall clearly state that it constitutes a notice in lieu of return. A notice in lieu of return is considered a returned check subject to the requirements of this subpart.

Alternative 1 for paragraph (g)

(g) *Extension of deadline.* The deadline for return or notice of dishonor or nonpayment under the UCC or Regulation J (12 CFR part 210), or §§ 229.36(f)(3) and (4) is extended to the time of dispatch of such return or notice if the depositary bank (or the receiving bank, if the depositary bank is unidentifiable) receives the returned check or notice:

(1) On or before the depositary bank's (or receiving bank's) next banking day following the otherwise applicable deadline by the earlier of the close of that banking day or a cutoff hour of 2:00 p.m. (local time of the depositary bank or receiving bank) or later set by the depositary bank (or receiving bank) under UCC 4–108, for all deadlines other than those described in paragraph (g)(2) of this section; or

(2) Prior to the cut-off hour for the next processing cycle (if sent to a returning bank), or on the next banking day (if sent to the depositary bank), for a deadline falling on a Saturday that is a banking day (as defined in the applicable UCC) for the paying bank.

Alternative 2 for paragraph (g)

(g) *Extension of deadline.* The deadline for return or notice of dishonor under the UCC or Regulation J (12 CFR part 210), or §§ 229.36(d)(3) and (4) is extended to the time of dispatch of such return or notice if the depositary bank (or the receiving bank, if the depositary bank is unidentifiable) receives the returned check or notice:

(1) On or before the depositary bank's (or receiving bank's) next banking day following the otherwise applicable deadline by the earlier of the close of that banking day or a cutoff hour of 2:00 p.m. (local time of the depositary bank or receiving bank) or later set by the depositary bank (or receiving bank) under UCC 4–108, for all deadlines other than those described in paragraph (e)(2) of this section; or

(2) Prior to the cut-off hour for the next processing cycle (if sent to a returning bank), or on the next banking day (if sent to the depositary bank), for a deadline falling on a Saturday that is a banking day (as defined in the applicable UCC) for the paying bank.

Alternative 1 for paragraph (h)

(h) *Payable-through and payable-at checks.* Except for paragraph (e) of this section, for purposes of this subpart, a check payable at or through a paying bank is considered to be drawn on that bank.

Alternative 2 for paragraph (h)

(h) [Same as Alternative 1.]

Alternative 1 for paragraph (i)

(i) *Reliance on routing number.* A paying bank may return a returned check based on any routing number designating the depositary bank appearing on the returned check in the depositary bank's indorsement.

Alternative 2 for paragraph (i)

(i) [Same as Alternative 1.]

5. Section 229.32 is revised to read as follows:

§ 229.32 Returning bank's responsibility for return of checks.

Alternative 1 for paragraph (a)

(a) *Return of checks.* (1) A returning bank may send the returned check to the depositary bank, to any bank agreeing to handle the returned check, or as provided in paragraph (a)(2) of this section.

(2) A returning bank that is unable to identify the depositary bank with respect to a returned check may send the returned check to any collecting bank that handled the

returned check for forward collection if the returning bank was not a collecting bank with respect to the returned check, or to a prior collecting bank, if the returning bank was a collecting bank with respect to the returned check. A returning bank sending a returned check under this paragraph to a bank must advise the bank to which the returned check is sent that the returning bank is unable to identify the depositary bank.

(3) A returning bank may convert a returned check to a qualified returned check. A qualified returned check shall be encoded in magnetic ink with the routing number of the depositary bank, the amount of the returned check, and a "2" in the case of an original check (or a "5" in the case of a substitute check) in position 44 of the qualified return MICR line as a return identifier. A qualified returned original check shall be encoded in accordance with ANS X9.13, and a qualified returned substitute check shall be encoded in accordance with ANS X9.100–140.

Alternative 2 for paragraph (a)

(a) *Return of checks.* (1) Subject to the requirement for expeditious return in paragraph (b) of this section, a returning bank may send the returned check to the depositary bank, to any bank agreeing to handle the returned check, or as provided in paragraph (a)(2) of this section.

(2) A returning bank that is unable to identify the depositary bank with respect to a returned check may send the returned check to any collecting bank that handled the returned check for forward collection if the returning bank was not a collecting bank with respect to the returned check, or to a prior collecting bank, if the returning bank was a collecting bank with respect to the returned check. A returning bank sending a returned

check under this paragraph to a bank must advise the bank to which the returned check is sent that the returning bank is unable to identify the depositary bank.

(3) A returning bank may convert a returned check to a qualified returned check. A qualified returned check shall be encoded in magnetic ink with the routing number of the depositary bank, the amount of the returned check, and a "2" in the case of an original check (or a "5" in the case of a substitute check) in position 44 of the qualified return MICR line as a return identifier. A qualified returned original check shall be encoded in accordance with ANS X9.13, and a qualified returned substitute check shall be encoded in accordance with ANS X9.100–140.

Alternative 1 for paragraph (b)

(b) [Reserved.]

Alternative 2 for paragraph (b)

(b) *Expeditious return of checks.* (1) Except as provided in paragraph (c) of this section, a returning bank shall return the check in an expeditious manner such that the check would normally be received by the depositary bank not later than 2:00 p.m. (local time of the depositary bank) on the second business day following the banking day on which the check was presented to the paying bank.

(2) If the second business day following the banking day on which the check was presented to the paying bank is not a banking day for the depositary bank, the returning bank satisfies the expeditious return requirement if it sends the returned check in a manner such that the check would normally be received by the depositary bank on or before the depositary bank's next banking day.

Alternative 1 for paragraph (c)

(c) [Reserved.]

Alternative 2 for paragraph (c)

(c) *Exceptions to the expeditious return of checks.* (1) The expeditious return requirement of paragraph (b) of this section does not apply if—

(i) The returning bank does not have an agreement to send electronic returned checks to the depositary bank or to another returning bank that has an agreement to send electronic returned checks to the depositary bank, and the returning bank has not otherwise agreed to handle the returned check expeditiously under paragraph (b) of this section;

(ii) The check is deposited in a depositary bank that is not subject to subpart B of this regulation; or

(iii) the paying bank is unable to identify the depositary bank with respect to the check.

Alternative 1 for paragraph (d)

(d) *Notice in lieu of return.* If a check is unavailable for return, the returning bank may send in its place a copy of the front and back of the returned check, or, if no copy is available, a written notice of nonpayment containing the information specified in §229.31(d). The copy or written notice shall clearly state that it constitutes a notice in lieu of return. A notice in lieu of return is considered a returned check subject to the requirements of this section and the other requirements of this subpart.

Alternative 2 for paragraph (d)

(d) *Notice in lieu of return.* If a check is unavailable for return, the returning bank may send in its place a copy of the front and back of the returned check, or, if no copy is available, a written notice of nonpayment containing the information specified in paragraph (d)(2).

(2)(i) To the extent available to the returning bank, notice must include the information contained in the check's MICR line when the check is received by the returning bank, as well as—

(A) Name of the paying bank;

(B) Name of the payee(s);

(C) Amount;

(D) Date of the indorsement of the depositary bank;

(E) Account number of the customer(s) of the depositary bank;

(F) Branch name or number of the depositary bank from its indorsement;

(G) The bank name, routing number, and trace or sequence number associated with the indorsement of the depositary bank; and

(H) Reason for nonpayment.

(ii) If the returning bank is not sure of the accuracy of an item of information, it shall include the information required by this paragraph to the extent possible, and identify any item of information for which the bank is not sure of the accuracy.

(iii) The notice may include other information from the check that may be useful in identifying the check being returned and the customer.

(3) The copy or written notice shall clearly state that it constitutes a notice in lieu of return. A notice in lieu of return is considered a returned check subject to the requirements of this section and the other requirements of this subpart.

Alternative 1 for paragraph (e)

(e) *Settlement*. A returning bank shall settle with a bank sending a returned check to it for return by the same means that it settles or would settle with the sending bank for a check received for forward collection drawn on the depositary bank. This settlement is final when made.

Alternative 2 for paragraph (e)

(e) [Same as Alternative 1.]

Alternative 1 for paragraph (f)

(f) *Charges*. A returning bank may impose a charge on a bank sending a returned check for handling the returned check.

Alternative 2 for paragraph (f)

(f) [Same as Alternative 1.]

Alternative 1 for paragraph (g)

(g) *Reliance on routing number*. A returning bank may return a returned check based on any routing number designating the depositary bank appearing on the returned check in the depositary bank's indorsement or in magnetic ink on a qualified returned check.

Alternative 2 for paragraph (g)

(g) [Same as Alternative 1.]

6. Section 229.33 is amended to read as follows:

§ 229.33 Depositary bank's responsibility for returned checks and notices of nonpayment.

Alternative 1 for paragraph (a)

(a) *Acceptance of electronic returned checks and electronic notices of nonpayment.* A depositary bank's agreement with the transferor bank governs the acceptance of electronic returned checks and electronic written notices of nonpayment.

Alternative 2 for paragraph (a)

(a) *Acceptance of electronic returned checks*. A depositary bank's agreement with the transferor bank governs the acceptance of electronic returned checks.

Alternative 1 for paragraph (b)

(b) *Acceptance of paper returned checks and paper notices of nonpayment*. (1) A depositary bank shall accept paper returned checks and paper written notices of nonpayment during its banking day—

(i) At a location, if any, at which presentment of paper checks for forward collection is requested by the depositary bank; and

(ii) (A) At a branch, head office, or other location consistent with the name and address of the bank in its indorsement on the check;

(B) If no address appears in the indorsement, at a branch or head office associated with the routing number of the bank in its indorsement on the check; or

(C) If no routing number or address appears in its indorsement on the check, at any branch or head office of the bank.

(2) A depositary bank may require that paper returned checks be separated from forward collection checks.

Alternative 2 for paragraph (b)

(b) *Acceptance of paper returned checks*. (1) A depositary bank shall accept paper returned checks during its banking day—

(i) At a location, if any, at which presentment of paper checks for forward collection is requested by the depositary bank; and

(ii) (A) At a branch, head office, or other location consistent with the name and address of the bank in its indorsement on the check;

(B) If no address appears in the indorsement, at a branch or head office associated with the routing number of the bank in its indorsement on the check; or

(C) If no routing number or address appears in its indorsement on the check, at any branch or head office of the bank.

(2) A depositary bank may require that paper returned checks be separated from forward collection checks.

Alternative 1 for paragraph (c)

(c) *Acceptance of oral notices of nonpayment.* A depositary bank shall accept oral notices of nonpayment during its banking day—

(1) At the telephone number indicated in the indorsement; and

(2) At any other number held out by the bank for receipt of notice of nonpayment.

Alternative 2 for paragraph (c)

(c) [Reserved.]

Alternative 1 for paragraph (d)

(d) *Payment.* (1) A depositary bank shall pay the returning bank or paying bank returning the check to it for the amount of the check prior to the close of business on the banking day on which it received the check ("payment date") by—

(i) Debit to an account of the depositary bank on the books of the returning bank or paying bank;

(ii) Cash;

(iii) Wire transfer; or

(iv) Any other form of payment acceptable to the returning bank or paying bank.

(2) The proceeds of the payment must be available to the returning bank or paying bank in cash or by credit to an account of the returning bank or paying bank on or as of the payment date. If the payment date is not a banking day for the returning bank or paying bank or the depositary bank is unable to make the payment on the payment date, payment shall be made by the next day that is a banking day for the returning bank or paying bank. These payments are final when made.

Alternative 2 for paragraph (d)

(d) [Same as Alternative 1.]

Alternative 1 for paragraph (e)

(e) *Misrouted returned checks and written notices of nonpayment.* If a bank receives a returned check or written notice of nonpayment on the basis that it is the depositary bank, and the bank determines that it is not the depositary bank with respect to the check or notice, it shall either promptly send the returned check or notice to the depositary bank

directly or by means of a returning bank agreeing to handle the returned check or notice, or send the check or notice back to the bank from which it was received.

Alternative 2 for paragraph (e)

(e) *Misrouted returned checks*. If a bank receives a returned check on the basis that it is the depositary bank, and the bank determines that it is not the depositary bank with respect to the check or notice, it shall either promptly send the returned check to the depositary bank directly or by means of a returning bank agreeing to handle the returned check or notice, or send the check back to the bank from which it was received.

Alternative 1 for paragraph (f)

(f) *Charges.* A depositary bank may not impose a charge for accepting and paying checks being returned to it.

Alternative 2 for paragraph (f)

(f) [Same as Alternative 1.]

Alternative 1 for paragraph (g)

(g) *Notification to customer*. If the depositary bank receives a returned check, notice of nonpayment, or notice of recovery under §229.35(b), it shall send or give notice to its customer of the facts by midnight of the banking day following the banking day on which it received the returned check, notice of nonpayment, or notice of recovery, or within a longer reasonable time.

Alternative 2 for paragraph (g)

(g) *Notification to customer*. If the depositary bank receives a returned check or notice of recovery under §229.35(b), it shall send or give notice to its customer of the facts by

midnight of the banking day following the banking day on which it received the returned check or notice of recovery, or within a longer reasonable time.

7. Section 229.34 is amended to read as follows:

§ 229.34 Warranties and indemnities.

(a) *Warranties with respect to electronic checks and electronic returned checks.* (1) Each bank that transfers or presents an electronic check or electronic returned check and receives a settlement or other consideration for it warrants that—

(i) The electronic image accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated and the electronic information contains an accurate record of all MICR line information required for a substitute check under § 229.2(aaa) of this part and the amount of the check, and

(ii) No person will receive a transfer, presentment, or return of, or otherwise be charged for an electronic check or electronic returned check, the original check, a substitute check, or a paper or electronic representation of a substitute check such that the person will be asked to make payment based on a check it has already paid.

(2) Each bank that makes the warranties under paragraph (a)(1) of this section makes the warranties to—

(i) In the case of transfers for collection or presentment, the transferee bank, any subsequent collecting bank, the paying bank, and the drawer; and

(ii) In the case of transfers for return, the transferee returning bank, any subsequent returning bank, the depositary bank, and the owner.

(b) *Indemnity with respect to an electronic image or electronic information not related to a paper check.* Each bank that transfers or presents an electronic image or electronic information that is not derived from a paper check and for which it receives a settlement or other consideration shall indemnify each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against losses as set forth in paragraph (i) that result from the fact that the electronic image or electronic information is not derived from a paper check.

(c) *Transfer and presentment warranties with respect to a remotely created check.* (1) A bank that transfers or presents a remotely created check and receives a settlement or other consideration warrants to the transferee bank, any subsequent collecting bank, and the paying bank that the person on whose account the remotely created check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check. For purposes of this paragraph (c)(1), "account" includes an account as defined in §229.2(a) as well as a credit or other arrangement that allows a person to draw checks that are payable by, through, or at a bank.

(2) If a paying bank asserts a claim for breach of warranty under paragraph (c)(1) of this section, the warranting bank may defend by proving that the customer of the paying bank is precluded under UCC 4–406, as applicable, from asserting against the paying bank the unauthorized issuance of the check.

(d) *Settlement amount, encoding, and offset warranties.* (1) Each bank that presents one or more checks to a paying bank and in return receives a settlement or other consideration warrants to the paying bank that the total amount of the checks presented is equal to the total amount of the settlement demanded by the presenting bank from the paying bank.

(2) Each bank that transfers one or more checks or returned checks to a collecting bank, returning bank, or depositary bank and in return receives a settlement or other consideration warrants to the transferee bank that the accompanying information, if any, accurately indicates the total amount of the checks or returned checks transferred.

(3) Each bank that presents or transfers a check or returned check warrants to any bank that subsequently handles it that, at the time of presentment or transfer, the information encoded after issue regarding the check or returned check is accurate. For purposes of this paragraph, the information encoded after issue regarding the check or returned check means any information that could be encoded in the MICR line of a paper check.

(4) If a bank settles with another bank for checks presented, or for returned checks for which it is the depositary bank, in an amount exceeding the total amount of the checks, the settling bank may set off the excess settlement amount against subsequent settlements for checks presented, or for returned checks for which it is the depositary bank, that it receives from the other bank.

(e) *Returned check warranties.* (1) Each paying bank or returning bank that transfers a returned check and receives a settlement or other consideration for it warrants to the transferee returning bank, to any subsequent returning bank, to the depositary bank, and to the owner of the check, that—

(i) The paying bank, or in the case of a check payable by a bank and payable through another bank, the bank by which the check is payable, returned the check within its deadline under the UCC or §229.31(g) of this part;

(ii) It is authorized to return the check;

(iii) The check has not been materially altered; and

(iv) In the case of a notice in lieu of return, the check has not and will not be returned.

(2) These warranties are not made with respect to checks drawn on the Treasury of the United States, U.S. Postal Service money orders, or checks drawn on a state or a unit of general local government that are not payable through or at a bank.

Alternative 1 for paragraph (f)

(f) *Notice of nonpayment warranties*. (1) Each paying bank that gives a notice of nonpayment warrants to the transferee bank, to any subsequent transferee bank, to the depositary bank, and to the owner of the check that—

(i) The paying bank, or in the case of a check payable by a bank and payable through another bank, the bank by which the check is payable, returned or will return the check within its deadline under the UCC or §229.31(g) of this part;

(ii) It is authorized to send the notice; and

(iii) The check has not been materially altered.

(2) These warranties are not made with respect to checks drawn on the Treasury of the United States, U.S. Postal Service money orders, or check drawn on a state or a unit of general local government that are not payable through or at a bank.

Alternative 2 for paragraph (f)

(f) [Reserved.]

(g) *Truncating bank indemnity.* (1) The indemnity described in paragraph (g)(2) of this section is provided by a depositary bank that—

(i) Is a truncating bank under §229.2(eee)(2) because it accepts deposit of an electronic check related to an original check;

(ii) Does not receive the original check;

(iii) Receives settlement or other consideration for an electronic check or substitute check related to the original check; and

(iv) Does not receive a return of the check unpaid.

(2) A bank described in paragraph (g)(1) of this section shall indemnify a depositary bank that accepts the original check for deposit for losses incurred by that depositary bank if the loss is due to the check having already been paid.

(h) *Damages.* Damages for breach of the warranties in this section shall not exceed the consideration received by the bank that presents or transfers a check or returned check, plus interest compensation and expenses related to the check or returned check, if any.

(i) *Indemnity amounts.* (1) The amount of the indemnity in paragraphs (b) and (g) of this section shall not exceed the sum of—

(i) The amount of the loss of the indemnified bank, up to the amount of the settlement or other consideration received by the indemnifying bank; and

(ii) Interest and expenses of the indemnified bank (including costs and reasonable attorney's fees and other expenses of representation).

(2)(i) If a loss described in paragraph (b) or (g) of this section results in whole or in part from the indemnified bank's negligence or failure to act in good faith, then the indemnity amount described in paragraph (i)(1) shall be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified bank.

(ii) Nothing in this paragraph (i)(2) reduces the rights of a person under the UCC or other applicable provision of state or federal law.

(j) *Tender of defense.* If a bank is sued for breach of a warranty or for indemnity under this section, it may give a prior bank in the collection or return chain written notice of the litigation, and the bank notified may then give similar notice to any other prior bank. If the notice states that the bank notified may come in and defend and that failure to do so will bind the bank notified in an action later brought by the bank giving the notice as to any determination of fact common to the two litigations, the bank notified is so bound unless after seasonable receipt of the notice the bank notified does come in and defend.

(k) *Notice of claim.* Unless a claimant gives notice of a claim for breach of warranty or for indemnity under this section to the bank that made the warranty or indemnification within 30 days after the claimant has reason to know of the breach or facts and circumstances giving rise to the indemnity and the identity of the warranting bank, the warranting bank is discharged to the extent of any loss caused by the delay in giving notice of the claim.

8. In § 229.35, paragraph (a) and paragraph (d) are revised as follows:

§ 229.35 Indorsements.

(a) *Indorsement standards.* A bank (other than a paying bank) that handles a check during forward collection or a returned check shall indorse the check in a manner that permits a person to interpret the indorsement, in accordance with American National Standard (ANS) Specifications for Physical Check Indorsements, X9.100-111 (ANS X9.100-111) for a paper check, ANS X9.100-140 for a substitute check, and American National Standard Specifications for Electronic Exchange of Check and Image Data – Domestic, X9.100-187 (ANS X9.100-187), for an electronic check, unless the Board by rule or order determines that different standards apply or the parties otherwise agree.

(b) * * * *

(c) * * * *

(1) * * *

(2) * * *

(d) *Indorsement for depositary bank.* A depositary bank may arrange with another bank to apply the other bank's indorsement as the depositary bank indorsement, provided that any indorsement of the depositary bank on the check avoids the area reserved for the depositary bank indorsement as specified in the indorsement standard applicable to the check under paragraph (a) of this section. The other bank indorsing as depositary bank is considered the depositary bank for purposes of subpart C of this part.

9. In § 229.36

A. paragraphs (a) are (b) are revised;

B. paragraph (e) is reserved; and

C. paragraph (f) is revised.

The revisions and reservation read as follows:

§ 229.36 Presentment and issuance of checks.

(a) *Receipt of electronic checks.* A paying bank's receipt of an electronic check is governed by the paying bank's agreement with the presenting bank.

(b) Receipt of paper checks. (1) A check in paper form is considered received by the paying bank when it is received–

(i) At a location to which delivery is requested by the paying bank;

(ii) At a branch, head office, or other location consistent with the name and address of the bank on the check if the bank is identified on the check by name and address;

(iii) At an address of the bank associated with the routing number on the check, whether contained in the MICR line or in fractional form; or

(iv) At any branch or head office, if the bank is identified on the check by name without address.

(2) A bank may require that checks presented to it as a paying bank be separated from returned checks.

(3) * * *

(4) * * *

(d) * * * * *

(e) [Reserved.]

(f) *Same-day settlement.* (1) A paper check is considered presented, and a paying bank must settle for or return the check pursuant to paragraph (f)(2) of this section, if a presenting bank delivers the check in accordance with reasonable delivery requirements established by the paying bank and demands payment under this paragraph (f)—

(i) At a location designated by the paying bank for receipt of paper checks under this paragraph (f) at which the paying bank would be considered to have received the paper check under paragraph (b) of this section or, if no location is designated, at any location described in paragraph (b) of this section; and

(ii) By 8:00 a.m. on a business day (local time of the location described in paragraph (f)(1)(i) of this section).

(2) A paying bank may require that paper checks presented for settlement pursuant to this paragraph (d)(1) be separated from other forward-collection checks or returned checks.

(3) If presentment of a paper check meets the requirements of paragraph (f)(1) of this section, the paying bank is accountable to the presenting bank for the amount of the check unless, by the close of Fedwire on the business day it receives the check, it either–

(i) Settles with the presenting bank for the amount of the check by credit to an account at a Federal Reserve Bank designated by the presenting bank; or

(ii) Returns the check.

(4)Notwithstanding paragraph (f)(3) of this section, if a paying bank closes on a business day and receives presentment of a paper check on that day in accordance with paragraph (f)(1) of this section,

(i) The paying bank is accountable to the presenting bank for the amount of the check unless, by the close of Fedwire on its next banking day, it either–

(A) Settles with the presenting bank for the amount of the check by credit to an account at a Federal Reserve Bank designated by the presenting bank; or

(B) Returns the check.

(ii) If the closing is voluntary, unless the paying bank settles for or returns the check in accordance with paragraph (f)(3) of this section, it shall pay interest compensation to the presenting bank for each day after the business day on which the check was presented until the paying bank settles for the check, including the day of settlement.

10. In § 229.38, paragraphs (a), (b), (c) and (d) are revised to read as follows:

§ 229.38 Liability.

Alternative 1 for paragraph (a)

(a) *Standard of care; liability; measure of damages.* A bank shall exercise ordinary care and act in good faith in complying with the requirements of this subpart. A bank that fails to exercise ordinary care or act in good faith under this subpart may be liable to the depositary bank, the depositary bank's customer, the owner of a check, or another party to the check. The measure of damages for failure to exercise ordinary care is the amount of the loss incurred, up to the amount of the check, reduced by the amount of the loss that party would have incurred even if the bank had exercised ordinary care. A bank that fails to act in good faith under this subpart may be liable for other damages, if any, suffered by the party as a proximate consequence. Subject to a bank's duty to exercise ordinary care or act in good faith in choosing the means of return or notice of nonpayment, the bank is not liable for the insolvency, neglect, misconduct, mistake, or default of another bank or person, or for loss or destruction of a check or notice of nonpayment in transit or in the possession of others. This section does not affect a paying bank's liability to its customer under the UCC or other law.

Alternative 2 for paragraph (a)

(a) *Standard of care; liability; measure of damages*. A bank shall exercise ordinary care and act in good faith in complying with the requirements of this subpart. A bank that fails to exercise ordinary care or act in good faith under this subpart may be liable to the depositary bank, the depositary bank's customer, the owner of a check, or another party to the check. The measure of damages for failure to exercise ordinary care is the amount

of the loss incurred, up to the amount of the check, reduced by the amount of the loss that party would have incurred even if the bank had exercised ordinary care. A bank that fails to act in good faith under this subpart may be liable for other damages, if any, suffered by the party as a proximate consequence. Subject to a bank's duty to exercise ordinary care or act in good faith in choosing the means of return, the bank is not liable for the insolvency, neglect, misconduct, mistake, or default of another bank or person, or for loss or destruction of a check in transit or in the possession of others. This section does not affect a paying bank's liability to its customer under the UCC or other law.

(b) [Reserved.]

Alternative 1 for paragraph (c)

(c) *Comparative negligence.* If a person, including a bank, fails to exercise ordinary care or act in good faith under this subpart in indorsing a check (§229.35), accepting a returned check or notice of nonpayment (§§229.33(a), (b), and (c)), or otherwise, the damages incurred by that person under §229.38(a) shall be diminished in proportion to the amount of negligence or bad faith attributable to that person.

Alternative 2 for paragraph (c)

(c) *Comparative negligence.* If a person, including a bank, fails to exercise ordinary care or act in good faith under this subpart in indorsing a check (§229.35), accepting a returned check (§§229.33(a) and (b)), or otherwise, the damages incurred by that person under §229.38(a) shall be diminished in proportion to the amount of negligence or bad faith attributable to that person.

(d) *Responsibility for certain aspects of checks* —(1) A paying bank, or in the case of a check payable through the paying bank and payable by another bank, the bank by which

the check is payable, is responsible for damages under paragraph (a) of this section to the extent that the condition of the check when issued by it or its customer adversely affects the ability of a bank to indorse the check legibly in accordance with §229.35. A depositary bank is responsible for damages under paragraph (a) of this section to the extent that the condition of the back of a check arising after the issuance of the check and prior to acceptance of the check by it adversely affects the ability of a bank to indorse the check legibly in accordance with §229.35. A reconverting bank is responsible for damages under paragraph (a) of this section to the extent that the condition of the back of a substitute check transferred, presented, or returned by it—

(i) Adversely affects the ability of a subsequent bank to indorse the check legibly in accordance with §229.35; or

(ii) Causes an indorsement that previously was applied in accordance with §229.35 to become illegible.

(2) Responsibility under this paragraph (d) shall be treated as negligence of the paying bank, depositary bank, or reconverting bank for purposes of paragraph (b) of this section.

11. § 229.39 is revised to read as follows:

§ 229.39 Insolvency of bank.

(a) *Duty of receiver to return unpaid checks.* A check or returned check in, or coming into, the possession of a paying bank, collecting bank, depositary bank, or returning bank that suspends payment, and which is not paid, shall be returned by the receiver, trustee, or agent in charge of the closed bank to the bank or customer that transferred the check to the closed bank.

(b) *Claims against banks for checks not returned by receiver.* If a check or returned check is not returned by the receiver, trustee, or agent in charge of the closed bank under paragraph (a) of this section, a bank shall have claims with respect to the check or returned check as follows—

(1) If the paying bank has finally paid the check, or if a depositary bank is obligated to pay the returned check, and suspends payment without making a settlement for the check or returned check with the prior bank that is or becomes final, the prior bank has a claim against the paying bank or the depositary bank.

(2) If a collecting bank, paying bank, or returning bank receives settlement from a subsequent bank for a check or returned check, which settlement is or becomes final, and suspends payments without making a settlement for the check with the prior bank, which is or becomes final, the prior bank has a claim against the collecting bank or returning bank.

(c) Preferred claim against presenting bank for breach of warranty. If a paying bank settles with a presenting bank for one or more checks, and if the presenting bank breaches a warranty specified in §229.34(d)(1) or (3) with respect to those checks and suspends payments before satisfying the paying bank's warranty claim, the paying bank has a preferred claim against the presenting bank for the amount of the warranty claim.

(d) *Finality of settlement.* If a paying bank or depositary bank gives, or a collecting bank, paying bank, or returning bank gives or receives, a settlement for a check or returned check and thereafter suspends payment, the suspension does not prevent or interfere with the settlement becoming final if such finality occurs automatically upon the lapse of a certain time or the happening of certain events.

12. In § 229.40, paragraph (a) is revised and paragraph (b) is deleted to read as follows:

§ 229.40 Effect of merger transaction.

(a) For purposes of this subpart, two or more banks that have engaged in a merger transaction may be considered to be separate banks for a period of one year following the consummation of the merger transaction.

13. Section 229.42 is revised to read as follows:

§ 229.42 Exclusions.

Alternative 1 for this section

The notice-of-nonpayment (§229.31(d)) and same-day settlement (§229.36(d)) requirements of this subpart do not apply to a check drawn upon the United States Treasury, to a U.S. Postal Service money order, or to a check drawn on a state or a unit of general local government that is not payable through or at a bank.

Alternative 2 for this section

The expeditious return (§§ 229.31(b) and 229.32(b)) and same-day settlement (§229.36(d)) requirements of this subpart do not apply to a check drawn upon the United States Treasury, to a U.S. Postal Service money order, or to a check drawn on a state or a unit of general local government that is not payable through or at a bank.

14. In § 229.43, paragraphs (a)(2) and paragraph (b) are revised to read as follows:

§ 229.43 Checks payable in Guam, American Samoa, and the Northern Mariana Islands.

(a) * * *

(1) * * *

(2) *Pacific island check* means—

(i) A demand draft drawn on or payable through or at a Pacific island bank, which is not a check as defined in §229.2(k); and

(ii) Includes an electronic image of or electronic information related to a demand draft drawn on or payable through or at a Pacific island bank that a bank sends to a receiving bank pursuant to an agreement with the receiving bank, except as otherwise provided in this section.

Alternative 1 for paragraph (b)

(b) *Rules applicable to Pacific island checks.* To the extent a bank handles a Pacific island check as if it were a check defined in §229.2(k), the bank is subject to the following sections of this part (and the word "check" in each such section is construed to include a Pacific island check)—

(1) §229.32;

(2) §229.33(a), (b), (c), (d), (e), and (f);

(3) §229.34(a), (b), (c), (d)(2), (d)(3), (g), (h), (i) and (j) ;

(4) §229.35; for purposes of §229.35(c), the Pacific island bank is deemed to be a bank;

(5) §229.36(d);

(6) §229.37;

(7) §229.38;

(8) §229.39(a), (b), and (d); and

(9) §§229.40 through 229.42.

* * * * *

Alternative 2 for paragraph (b)

(b) *Rules applicable to Pacific island checks.* To the extent a bank handles a Pacific island check as if it were a check defined in §229.2(k), the bank is subject to the following sections of this part (and the word "check" in each such section is construed to include a Pacific island check)—

(1) §229.32;

(2) §229.33(a), (b), (c), (d), (e), and (f);

(3) §229.34(a), (b), (c), (d)(2), (d)(3), (g), (h), (i) and (j) ;

(4) §229.35; for purposes of §229.35(c), the Pacific island bank is deemed to be a bank;

(5) §229.36(d);

(6) §229.37;

(7) §229.38;

(8) §229.39(a), (b), (c) and (e); and

(9) §§229.40 through 229.42.

* * * * *

SUBPART D—SUBSTITUTE CHECKS

15. In § 229.51, paragraphs (b)(1) through (b)(3) are revised to read as follows:

§ 229.51 General provisions governing substitute checks.

(a) * * * * *

(b) Reconverting-bank duties. A bank shall ensure that a substitute check for which it is the reconverting bank—

(1) Bears all indorsements applied by parties that previously handled the check in any form (including the original check, a substitute check, or another paper or electronic representation of such original check or substitute check) for forward collection or return;

(2) Identifies the reconverting bank in a manner that preserves any previous reconverting-bank identifications, in accordance with ANS X9.100-140; and

(3) Identifies the bank that truncated the original check, in accordance with ANS X9.100-140.

* * * * *

16. In § 229.52, paragraphs (a)(1) and (a)(2) are revised to read as follows:

§ 229.52 Substitute check warranties.

(a) Content and provision of substitute-check warranties. (1) A bank that transfers, presents, or returns a substitute check (or a paper or electronic representation of a substitute check) for which it receives consideration warrants to the parties listed in paragraph (b) of this section that—

(i) the substitute check meets the requirements for legal equivalence described in section 229.51(a)(1)-(2); and

(ii) no depositary bank, drawee, drawer, or indorser will receive presentment or return of, or otherwise be charged for, the substitute check, the original check, or a paper or electronic representation of the substitute check or original check such that that person will be asked to make a payment based on a check that it already has paid.

(2) A bank that rejects a check submitted for deposit and returns to its customer a substitute check (or a paper or electronic representation of a substitute check) makes the

warranties in paragraph (a)(1) of this section regardless of whether the bank received consideration.

(b) * * * * *

17. In § 229.53, paragraph (a) is revised to read as follows:

§ 229.53 Substitute check indemnity.

(a) Scope of indemnity. (1) A bank that transfers, presents, or returns a substitute check or a paper or electronic representation of a substitute check for which it receives consideration shall indemnify the recipient and any subsequent recipient (including a collecting or returning bank, the depositary bank, the drawer, the drawee, the payee, the depositor, and any indorser) for any loss incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check instead of the original check.

(2) A bank that rejects a check submitted for deposit and returns to its customer a substitute check (or a paper or electronic representation of a substitute check) shall indemnify the recipient as described in paragraph (a)(1) of this section regardless of whether the bank received consideration.

* * * * *

Appendix D to Part 229—Reserved

19. Appendix D to Part 229 is reserved. XXXV.

Appendix E to Part 229—Commentary

20. In § 229.2,

(A) Paragraphs (z), (dd), (vv) and (bbb) are revised; and

(B) Paragraph (ggg) is added

The revisions and additions read as follows:

II. Section 229.2 Definitions

z. *Paying Bank*

* * * * *

2. Allowing the payable-through bank additional time to forward checks to the payor and await return or pay instructions from the payor would delay the return of these checks, increasing the risks to depositary banks. Subpart C places on payable-through and payable-at banks the requirements of expeditious return based on the time the payable-through or payable-at bank received the check for forward collection.

* * * * *

21. In Commentary II. Section 229.2 *Definitions*

A. paragraph DD. 229(dd) is revised;

B. paragraph VV. 229.2(vv) is revised;

C. paragraph BBB. 229.2(bbb) and Example, are revised; and

D. paragraph GGG is added. The revisions and addition read as follows:

DD. 229.2(dd) Routing number

1. Each bank is assigned a routing number by an agent of the American Bankers Association. The routing number takes two forms—a fractional form and a nine-digit form. A paying bank is identified by both the fractional form routing number (which normally appears in the upper right hand corner of the check) and the nine-digit form.

The nine-digit form of the routing number of the paying bank generally is printed in magnetic ink near the bottom of the check (the MICR line; see ANS X9.13). In the case of an electronic image of a check, the routing number of the paying bank is contained in the electronic image of the check (in nine-digit form and fractional form), and, in the case of electronic information related to a check, the routing number of the paying bank is contained in the electronic information related to the check (in nine-digit form). When a check is payable by one bank but payable through another bank, the routing number appearing on the check is that of the payable-through bank, not the payor bank. Industry standards require depositary banks, subsequent collecting banks, and returning banks to place their routing numbers in nine-digit form in their indorsements. (See § 229.35 and commentary.)

* * * * *

VV. 229.2(vv) MICR Line

1. Information in the MICR line of a check must be printed in accordance with ANS X9.13 for original checks and ANS X9.100-140 for substitute checks, and must be contained in the electronic image of and electronic information related to a check in accordance with ANS X9.100-187. These standards could vary the requirements for printing the MICR line, such as by indicating circumstances under which the use of magnetic ink is not required. The banks exchanging the electronic check may determine the applicable standard for electronic checks and electronic returned checks.

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BBB. 229.2(bbb) Copy and Sufficient Copy

1. A copy must be a paper reproduction of a check, unless the parties sending and receiving the copy otherwise agree. Therefore, an electronic image is not a copy or a sufficient copy absent an agreement. However, if a customer has agreed to receive such information electronically, a bank that is required to provide a copy or sufficient copy may satisfy that requirement by providing an electronic image. (See § 229.58)

2. A sufficient copy, which is used to resolve claims related to the receipt of a substitute check, must be a copy of the original check.

3. A bank under § 229.53(b)(3) may limit its liability for an indemnity claim and under §§ 229.54(e)(2) and 229.55(c)(2) may respond to an expedited recredit claim by providing the claimant with a copy of a check that accurately represents all of the information on the front and back of the original check as of the time the original check was truncated or that otherwise is sufficient to determine the validity of the claim against the bank.

Examples.

a. A copy of an original check that accurately represents all the information on the front and back of the original check as of the time of truncation would constitute a sufficient copy if that copy resolved the claim. For example, if resolution of the claim required accurate payment and indorsement information, an accurate copy of the front and back of a legible original check (including but not limited to a substitute check) would be a sufficient copy.

b. A copy of the original check that does not accurately represent all the information on both the front and back of the original check also could be a

sufficient copy if such copy contained all the information necessary to determine the validity of the relevant claim. For instance, if a consumer received a substitute check that contained a blurry image of a legible original check, the consumer might seek an expedited recredit because his or her account was charged for $1,000, but he or she believed that the check was written for only $100. If the amount that appeared on the front of the original check was legible, an accurate copy of only the front of the original check that showed the amount of the check would be sufficient to determine whether or not the consumer's claim regarding the amount of the check was valid.

* * * * *

GGG. 229.2(ggg) Electronic Check and Electronic Returned Check

1. Banks often enter into agreements under which a check may be transferred, returned, or presented by sending an electronic image of the check, electronic information related to the check (e.g., MICR line information), or both, instead of transferring, returning, or presenting the paper check. The terms of the agreements may vary. For example, an agreement may provide that an electronic image of the check as well as other electronic information related to the check (such as MICR line information) must be sent. Alternatively, an agreement may provide that electronic information related to the check is sufficient and an image is not required. A sending bank and receiving bank may also agree, for example, that instead of sending the electronic check or electronic returned check directly to the receiving bank, the electronic check or electronic returned check may be sent to an intermediary that stores the electronic check or electronic returned

check on the receiving bank's behalf and makes the electronic check or electronic returned check available for the receiving bank to retrieve.

2. A sending bank must have an agreement with the receiving bank in order to send an electronic image of a check or electronic information related to a check instead of a paper check. The agreement to receive an electronic check or electronic returned check may be either bilateral or through a Federal Reserve Bank operating circular, clearinghouse rule, or other interbank agreement. (*See* UCC § 4-110).

3. ANS X9.100-187 is the most prevalent industry standard for electronic images of and electronic information related to checks and returned checks that will enable banks to create substitute checks. Multiple standards, however, exist that would enable a bank to create a substitute check from an electronic image of and electronic information related the check or returned check. Therefore, the banks exchanging electronic images and electronic information may agree that a different standard applies to electronic images and electronic information exchanged between the two banks. Additionally, banks that exchange checks electronically may agree to transfer, present, or return only electronic images of checks or only electronic information related to checks. In these situations, the sending bank and receiving bank will have agreed to a different standard as ANS X9.100-187 requires both an electronic image and electronic information.

4. These electronic checks and electronic returned checks are subject to subpart C, except as otherwise provided in that subpart. (*See* § 229.30 and commentary thereto).

Subpart C—Collection of Checks

22. Commentary XVI. Section 229.30 *Paying Bank's Responsibility for Return of Checks* is renumbered as Commentary XVII § 229.31;

23. New Commentary XVI. Section 229.30 *Electronic Images and Electronic Information* is added.

The renumbering and addition read as follows:

XVI. Section 229.30 Electronic Images and Electronic Information

Alternative 1 for paragraphs A and B

A. 229.30(a) Checks Under This Subpart

1. A bank may agree to receive an electronic check or electronic returned check from another bank instead of a paper check or returned check (See § 229.2(bbb) and commentary thereto). Section 229.30(a) does not give a bank the right to send an electronic image of a check or electronic information related to a check or returned check absent an agreement to do so with the receiving bank.

2. Electronic checks and electronic returned checks are subject to subpart C as if they were checks or returned checks, unless otherwise provided in subpart C. For example, § 229.31(d) requires a paying bank to provide a notice of nonpayment only if the paying bank returns a check in paper form. Additionally, §§ 229.33(a) and 229.36(a) specify that the parties' agreements govern the receipt of electronic returned checks and electronic checks, respectively, rather than the provisions in § 229.33(b) (Acceptance of paper returned checks) and § 229.36(b) (Receipt of paper checks). Section 229.34(a) sets forth warranties that are given only with respect to electronic checks and electronic returned checks. The parties may, by agreement, vary the effect of the provisions in

subpart C as they apply to electronic checks and electronic returned checks. (See § 229.37 and commentary thereto).

B. 229.30(b) Writings

1. Provisions in subpart C require that a paying bank or returning bank send information in writing. For example, § 229.31(f) requires that a notice in lieu be either a copy of the check or a written notice of nonpayment. A bank may send information required to be in writing in electronic form if the bank sending the information has an agreement with the bank receiving the information to do so.

Alternative 2 for paragraphs A and B

A. 229.30(a) Checks Under This Subpart

1. A bank may agree to receive an electronic check or electronic returned check from another bank instead of a paper check or returned check (See § 229.2(bbb) and commentary thereto). Section 229.30(a) does not give a bank the right to send an electronic image of a check or electronic information related to a check or returned check absent an agreement to do so with the receiving bank.

2. Electronic checks and electronic returned checks are subject to subpart C as if they were checks or returned checks, unless otherwise provided in subpart C. For example, §§ 229.33(a) and 229.36(a) specify that the parties' agreements govern the receipt of electronic returned checks and electronic checks, respectively, rather than the provisions in § 229.33(b) (Acceptance of paper returned checks) and § 229.36(b) (Receipt of paper checks). Section 229.34(a) sets forth warranties that are given only with respect to electronic checks and electronic returned checks. The parties may, by

agreement, vary the effect of the provisions in subpart C as they apply to electronic checks and electronic returned checks. (See § 229.37 and commentary thereto).

B. 229.30(b) Writings

1. Provisions in subpart C require that a paying bank or returning bank send information in writing. For example, § 229.31(f) requires that a notice in lieu be either a copy of the check or a written notice of nonpayment. A bank may send information required to be in writing in electronic form if the bank sending the information has an agreement with the bank receiving the information to do so.

24. Commentary XVII. § 229.31 is revised to read as follows:

Commentary XVII.§ 229.31 *Paying Bank's Responsibility for Return of Checks and Notices of Nonpayment*

Alternative 1 for paragraphs A through G

A. 229.31(a) Return of Checks

1. Routing of returned checks.

a. The paying bank acts, in effect, as an agent or subagent of the depositary bank in selecting a means of return. Under § 229.31(a), a paying bank is authorized to route the returned check in a variety of ways:

i. It may send the returned check directly to the depositary bank by sending an electronic returned check directly to the depositary bank if the paying bank has an agreement with the depositary bank to do so, or by using a courier or other means of delivery, bypassing returning banks; or

ii. It may send the returned check or electronic returned check to any returning bank agreeing to handle the returned check or electronic returned check, regardless of whether or not the returning bank handled the check for forward collection.

b. If the paying bank elects to return the check directly to the depositary bank, it is not necessarily required to return the check to the branch of first deposit. A paper check may be returned to the depositary bank at any physical location permitted under § 229.33(b).

2. a. In some cases, a paying bank will be unable to identify the depositary bank through the use of ordinary care and good faith. The Board expects that these cases will be unusual as depositary banks generally apply their indorsements electronically. A paying bank, for example, would be unable to identify the depositary bank if the depositary bank's indorsement is neither in an addenda record nor within the image of the check that was presented electronically. A paying bank, however, would not be "unable" to identify the depositary bank merely because the depositary bank's indorsement is available within the image rather than attached as an addenda record.

b. In cases where the paying bank is unable to identify the depositary bank, the paying bank may send the returned check to a returning bank that agrees to handle the returned check. The returning bank may be better able to identify the depositary bank.

c. In the alternative, the paying bank may send the check back up the path used for forward collection of the check. The presenting bank and prior collecting banks normally will be able to trace the collection path of the check through the use of their internal records in conjunction with the indorsements on the returned check. In these limited cases, the presenting bank or a prior collecting bank is required accept the

returned check and send it to another prior collecting bank in the path used for forward collection or to the depositary bank. If the paying bank has an agreement to send electronic returned checks to a bank that handled the check for forward collection, the paying bank may send the electronic returned check to that bank.

d. A paying bank returning a check to a prior collecting bank because it is unable to identify the depositary bank must advise that bank that it is unable to identify the depositary bank. This advice must be conspicuous, such as a stamp on each check for which the depositary bank is unknown if such checks are commingled with other returned checks, or, if such checks are sent in a separate cash letter, by one notice on the cash letter. In the case of an electronic returned check, the advice requirement may be satisfied as agreed to by the parties. The advice will warn the bank that this check will require special research and handling in accordance with § 229.32(a)(2). The returned check may not be prepared as a qualified return.

e. A paying bank also may send a check to a prior collecting bank to make a claim against that bank under § 229.35(b) where the depositary bank is insolvent or in other cases as provided in § 229.35(b). Finally, paying bank may make a claim against a prior collecting bank based on a breach of warranty under UCC 4–208.

3. Midnight deadline. Except for the extension permitted by § 229.31(g), discussed below, this section does not relieve a paying bank from the requirement for timely return (i.e., midnight deadline) under UCC 4–301 and 4–302, which continue to apply. Under UCC 4–302, a paying bank is "accountable" for the amount of a demand item, other than a documentary draft, if it does not pay or return the item or send notice of dishonor by its midnight deadline. Under UCC 3–418(c) and 4–215(a), late return

constitutes payment and would be final in favor of a holder in due course or a person who has in good faith changed his position in reliance on the payment. Thus, the UCC midnight deadline gives the paying bank an incentive to make a prompt return.

4. UCC provisions affected. This paragraph directly affects the following provisions of the UCC, and may affect other sections or provisions:

a. Section 4–301(e), in that instead of returning a check through a clearinghouse or to the presenting bank, a paying bank may send a returned check to the depositary bank or to a returning bank.

b. Section 4–301(a), in that settlement for returned checks is made under § 229.32(e), not by revocation of settlement.

B. 229.31(d) Notice of Nonpayment

1. Requirement

a. The paying bank must send a notice of nonpayment if it decides not to pay a check and sends the returned check in paper form. Except in the case where the returned check or a notice in lieu of return serves as the notice of nonpayment, the notice of nonpayment carries no value, and the check or substitute check must be returned in addition to the notice of nonpayment. A paying bank that sends an electronic returned check instead of a paper returned check, pursuant to an agreement to do so, is not required to send a notice of nonpayment. The paying bank must send the notice of nonpayment such that it is received by the depositary bank by 2:00 p.m. local time of the depositary bank on the second business day following presentment.

b. A bank identified by routing number as the paying bank is considered the paying bank under this regulation and would be required to provide a notice of

nonpayment even though that bank determined that the check was not drawn by a customer of that bank. (See commentary to the definition of paying bank in § 229.2(z)). A bank designated as a payable-through or payable-at bank and to which the check is sent for payment collection is responsible for the notice of nonpayment requirement. The payable-through or payable-at bank may contract with the payor with respect to its liability in discharging these responsibilities.

c. The paying bank should not send a notice of nonpayment until it has finally determined not to pay the check. Under § 229.34(e), by sending the notice the paying bank warrants that it has returned or will return the check. If a paying bank sends a notice and subsequently decides to pay the check, the paying bank may mitigate its liability on this warranty by notifying the depositary bank that the check has been paid.

d. The return of the check itself may serve as the required notice of nonpayment. In some cases, the returned check may be received by the depositary bank within the time requirements of § 229.31(d)(1) and no notice other than the return of the check will be necessary. If the check is not received by the depositary bank within the time limits for notice, the return of the check will not satisfy the notice requirement.

e. The requirement for notice does not affect the requirements for return of the check under the UCC (or § 229.31(e)). A paying bank is not responsible for failure to give notice of nonpayment to a party that has breached a presentment warranty under UCC 4–208, notwithstanding that the paying bank may have returned the check. (See UCC 4–208 and 4–302.)

2. Content of Notices

a. This paragraph provides that, to the extent the information is available to the paying bank, the notice must at a minimum contain the information contained in the check's MICR line when the check was received by the paying bank. This information includes the paying bank's routing number, the account number of the paying bank's customer, the check number, and auxiliary on-us fields for corporate checks, and may include the amount of the check.

b. If the paying bank cannot identify the depositary bank from the check itself, it may wish to send the notice to the earliest collecting bank it can identify and indicate that the notice is not being sent to the depositary bank. The collecting bank may be able to identify the depositary bank and forward the notice, but is under no duty to do so. In addition, the collecting bank may actually be the depositary bank.

c. A bank must identify an item of information if the bank is uncertain as to that item's accuracy. A bank may make this identification in accordance with generally applicable industry standards, or as otherwise agreed to by the parties.

3. Depositary banks not subject to subpart B.

a. Subpart B of this regulation applies only to "checks" deposited in transaction "accounts." A depositary bank with only time or savings accounts need not comply with the availability requirements of subpart B of Regulation CC. Thus, the notice of nonpayment requirement of § 229.31(d) does not apply to checks being returned to banks that do not hold accounts. The paying bank's midnight deadline in UCC 4-301 and 4-302 and § 210.12 of Regulation J (12 CFR 210.12), and the extension in § 229.31(g), would continue to apply to these checks.

b. The notice of nonpayment requirement applies only to "checks" deposited in a bank that is a "depository institution" under the EFA Act. Federal Reserve Banks, Federal Home Loan Banks, private bankers, and possibly certain industrial banks are not "depository institutions" within the meaning of the EFA Act and therefore are not subject to the expedited-availability requirements of subpart B of this regulation. Thus, the notice of nonpayment requirement of this section would not apply to a paying bank returning a check that was deposited in one of these banks.

4. Unidentifiable depositary banks

a. A paying bank that sends a paper check to a bank that handled the check for forward collection because the paying bank is unable to identify the depositary bank is not subject to the requirement for notice of nonpayment. Although the lack of requirement for notice of nonpayment under this paragraph will create risks for the depositary bank, in many cases the inability to identify the depositary bank will be due to the depositary bank's, or a collecting bank's, failure to indorse as required by § 229.35(a). If the depositary bank failed to use the proper indorsement, it should bear the risks of not receiving notice of nonpayment in a timely manner. Similarly, where the inability to identify the depositary bank is due to indorsements or other information placed on the back of the check by the depositary bank's customer or other prior indorser, the depositary bank should bear the risk that it cannot charge a returned check back to that customer.

b. This paragraph does not relieve a paying bank from the liability for not providing notice of nonpayment in accordance with § 229.31(d) in cases where the paying bank is itself responsible for the inability to identify the depositary bank, such as

when the paying bank's customer has used a check with printing or other material on the back in the area reserved for the depositary bank's indorsement, making the indorsement unreadable. (See § 229.38(c).)

c. A paying bank's return of a check to an unidentifiable depositary bank is subject to its midnight deadline under UCC 4–301, Regulation J (if the check is returned through a Federal Reserve Bank), and the extension provided in § 229.31(g).

C. 229.31(e) Identification of Returned Check

1. The reason for the return must be clearly indicated. A check is identified as a returned check if the front of that check indicates the reason for return, even though it does not specifically state that the check is a returned check. A reason such as "Refer to Maker" may be permissible in certain cases, such as when a drawer with a positive pay arrangement instructs the bank to return the check. By contrast, a reason such as "Refer to Maker" would not be permissible in cases where a check is being returned due to the paying bank having already paid the item. In such cases, the payee and not the drawer would have more information as to why the check is being returned.

2. If the returned check is a substitute check or electronic returned check, the reason for return information must be included such that it is retained on any subsequent substitute check. For substitute checks, this requirement could be met by placing the information (1) in the location on the front of the substitute check that is specified by ANS X9.100-140 or (2) within the image of the original check that appears on the front of the substitute check so that the information is retained on any subsequent substitute check. For electronic returned checks, this requirement could be met by including the reason for return in accordance with ANS X9.100-187. If the paying bank places the

returned check in a carrier envelope, the carrier envelope should indicate that it is a returned check but need not repeat the reason for return stated on the check if it in fact appears on the check.

D. 229.31(f) Notice in Lieu of Return

1. A notice in lieu of return may be used by a bank handling a returned check that has been lost or destroyed, including when the original returned check has been charged back as lost or destroyed as provided in § 229.35(b). Notice in lieu of return is permitted only when a bank does not have and cannot obtain possession of the check (or must retain possession of the check for protest) and does not have sufficient information to create a substitute check. For example, a bank that does not have the original check may have an image of both sides of the check, but the image may be insufficient, or may not be in the proper format**,** to create a substitute check. In that case, the check would be unavailable for return. A bank using a notice in lieu of return gives a warranty under § 229.34(e)(1)(iv) that the check, in any form, has not been and will not be returned.

2. A notice in lieu of return must be in writing (either paper or electronic, if agreed to by the parties), but not provided by telephone or other oral transmission. The requirement for a writing and the indication that the notice is a substitute for the returned check is necessary so that any returning bank and the depositary bank are informed that the notice carries value. A check that is lost or otherwise unavailable for return may be returned by sending a legible copy of both sides of the check or, if such a copy is not available to the paying bank, a written notice of nonpayment containing the information specified in § 229.31(d). The copy or written notice must clearly indicate it is a notice in lieu of return. Notice by a legible facsimile of both sides of the check may satisfy the

requirements for a notice in lieu of return. The paying bank may send an electronic image of both sides of the check as a notice in lieu of return only if it has an agreement to do so with the receiving bank. (See § 229.30(b)).

3. The requirement of this paragraph supersedes the requirement of UCC 4–301(a) as to the form and information required of a notice of dishonor or nonpayment.

4. The notice in lieu of return is subject to the provisions of and is treated like a returned check for purposes of this subpart. Reference in the regulation and this commentary to a returned check includes a notice in lieu of return unless the context indicates otherwise. For example, the notice of nonpayment requirement under § 229.31(d) may be satisfied by the notice in lieu of return if the notice in lieu meets the time and information requirements of § 229.31(d).

5. If not all of the information required by § 229.31(d) is available, the paying bank may make a claim against any prior bank handling the check as provided in § 229.35(b).

E. 229.31(g) Extension of Deadline

1. This paragraph permits extension of the deadlines in the UCC, Regulation J (12 CFR part 210) and §§ 229.36(f)(3) and (f)(4) of this part for returning a check for which the paying bank previously has settled (generally midnight of the banking day following the banking day on which the check is received by the paying bank) and for returning a check without settling for it (generally midnight of the banking day on which the check is received by the paying bank, or such other time provided by § 210.9 of Regulation J (12 CFR part 210) or §§ 229.36(f)(3) or (f)(4) of this part), in two circumstances:

a. A paying bank may, by agreement, send an electronic returned check instead of a paper returned check or may have a courier that leaves after midnight (or after any other applicable deadline) to deliver its forward-collection checks. This paragraph removes the constraint of the midnight deadline for returned checks if the returned check reaches the depositary bank (or receiving bank, if the depositary bank is unidentifiable) on or before the depositary bank's (or receiving bank's) next banking day following the otherwise applicable deadline by the earlier of the close of that banking day or a cutoff hour of 2:00 p.m. (local time of the depositary bank or receiving bank) or later set by the depositary bank (or receiving bank) under UCC 4–108. This paragraph applies to the extension of all midnight deadlines except Saturday midnight deadlines (see the following paragraph).

b. A paying bank may observe a banking day, as defined in the applicable UCC, on a Saturday, which is not a business day and therefore not a banking day under Regulation CC. In such a case, the UCC deadline for returning checks received and settled for on Friday, or for returning checks received on Saturday without settling for them, might require the bank to return the checks by midnight Saturday. However, the bank may not have its back-office operations staff available on Saturday to prepare and send the electronic returned checks, and the returning bank or depositary bank that would be receiving this electronic information may not have staff available to process it until Sunday night or Monday morning. This paragraph extends the midnight deadline if the returned checks reach the returning bank by a cut-off hour (usually on Sunday night or Monday morning) that permits processing during its next processing cycle or reach the depositary bank (or receiving bank) by the cut-off hour on its next banking day following

the Saturday midnight deadline. This paragraph applies exclusively to the extension of Saturday midnight deadlines.

2. The time limits that are extended in each case are the paying bank's midnight deadline for returning a check for which it has already settled and the paying bank's deadline for returning a check without settling for it in UCC 4–301 and 4–302, §§ 210.9 and 210.12 of Regulation J (12 CFR 210.9 and 210.12), and § 229.36(f)(3) and (f)(4) of this part.

3. If the paying bank has an agreement to do so with the receiving bank, the paying bank may satisfy its midnight or other return deadline by sending an electronic returned check prior to the expiration of the deadline. The time when the electronic returned check is considered to be received by the depositary bank is determined by the agreement. The paying bank satisfies its midnight or other return deadline by dispatching paper returned checks to another bank by courier, including a courier under contract with the paying bank, prior to expiration of the deadline.

4. This paragraph directly affects UCC 4–301 and 4–302 and §§ 210.9 and 210.12 of Regulation J (12 CFR 210.9 and 210.12) to the extent that this paragraph applies by its terms, and may affect other provisions.

F. 229.31(h) Payable Through and Payable at Checks

1. For purposes of subpart C, the regulation defines a payable-through or payable-at bank (which could be designated the collectible-through or collectible-at bank) as a paying bank. The requirements of subpart C are imposed on a payable-through or payable-at bank and are based on the time of receipt of the forward collection check by the payable-through or payable-at bank. This provision is intended to speed the return of

checks and receipt of notices of nonpayment for checks that are payable through or at a bank to the depositary bank.

2. A check sent for payment or collection to a payable-through or payable-at bank is not considered to be drawn on that bank for purposes of the midnight deadline provision of UCC 4–301.

G. 229.31(i) Reliance on Routing Number

1. Although § 229.35 requires that the depositary bank indorsement contain its nine-digit routing number, it is possible that a returned check will bear the routing number of the depositary bank in fractional, nine-digit, or other form. This paragraph permits a paying bank to rely on the routing number of the depositary bank as it appears on the check (in the depositary bank's indorsement) or in the electronic check sent pursuant to an agreement when the check, or electronic check, is received by the paying bank.

2. If there are inconsistent routing numbers, the paying bank may rely on any routing number designating the depositary bank. The paying bank is not required to resolve the inconsistency prior to processing the check. The paying bank remains subject to the requirement to act in good faith and use ordinary care under § 229.38(a).

Alternative 2 for paragraphs A through G

A. 229.31(a) Return of Checks

1. Routing of returned checks.

a. This subsection is subject to the requirements of expeditious return provided in § 229.31(b).

b. The paying bank acts, in effect, as an agent or subagent of the depositary bank in selecting a means of return. Under § 229.31(a), a paying bank is authorized to route the returned check in a variety of ways:

i. It may send the returned check directly to the depositary bank by sending an electronic returned check directly to the depositary bank if the paying bank has an agreement with the depositary bank to do so, or by using a courier or other means of delivery, bypassing returning banks; or

ii. It may send the returned check or electronic returned check to any returning bank agreeing to handle the returned check or electronic returned check, regardless of whether or not the returning bank handled the check for forward collection.

b. If the paying bank elects to return the check directly to the depositary bank, it is not necessarily required to return the check to the branch of first deposit. A paper check may be returned to the depositary bank at any physical location permitted under § 229.33(b).

2. a. In some cases, a paying bank will be unable to identify the depositary bank through the use of ordinary care and good faith. The Board expects that these cases will be unusual as depositary banks generally apply their indorsements electronically. A paying bank, for example, would be unable to identify the depositary bank if the depositary bank's indorsement is neither in an addenda record nor within the image of the check that was presented electronically. A paying bank, however, would not be "unable" to identify the depositary bank merely because the depositary bank's indorsement is available within the image rather than attached as an addenda record.

b. In cases where the paying bank is unable to identify the depositary bank, the paying bank may send the returned check to a returning bank that agrees to handle the returned check. The returning bank may be better able to identify the depositary bank.

c. In the alternative, the paying bank may send the check back up the path used for forward collection of the check. The presenting bank and prior collecting banks normally will be able to trace the collection path of the check through the use of their internal records in conjunction with the indorsements on the returned check. In these limited cases, the presenting bank or a prior collecting bank is required accept the returned check and send it to another prior collecting bank in the path used for forward collection or to the depositary bank. If the paying bank has an agreement to send electronic returned checks to a bank that handled the check for forward collection, the paying bank may send the electronic returned check to that bank.

d. A paying bank returning a check to a prior collecting bank because it is unable to identify the depositary bank must advise that bank that it is unable to identify the depositary bank. This advice must be conspicuous, such as a stamp on each check for which the depositary bank is unknown if such checks are commingled with other returned checks, or, if such checks are sent in a separate cash letter, by one notice on the cash letter. In the case of an electronic returned check, the advice requirement may be satisfied as agreed to by the parties. The advice will warn the bank that this check will require special research and handling in accordance with § 229.32(a)(2). The returned check may not be prepared as a qualified return.

e. A paying bank also may send a check to a prior collecting bank to make a claim against that bank under § 229.35(b) where the depositary bank is insolvent or in

other cases as provided in § 229.35(b). Finally, paying bank may make a claim against a prior collecting bank based on a breach of warranty under UCC 4–208.

3. Midnight deadline. Except for the extension permitted by § 229.31(g), discussed below, this section does not relieve a paying bank from the requirement for timely return (i.e., midnight deadline) under UCC 4–301 and 4–302, which continue to apply. Under UCC 4–302, a paying bank is "accountable" for the amount of a demand item, other than a documentary draft, if it does not pay or return the item or send notice of dishonor by its midnight deadline. Under UCC 3–418(c) and 4–215(a), late return constitutes payment and would be final in favor of a holder in due course or a person who has in good faith changed his position in reliance on the payment. Thus, the UCC midnight deadline gives the paying bank an incentive to make a prompt return.

4. UCC provisions affected. This paragraph directly affects the following provisions of the UCC, and may affect other sections or provisions:

a. Section 4–301(d), in that instead of returning a check through a clearinghouse or to the presenting bank, a paying bank may send a returned check to the depositary bank or to a returning bank.

b. Section 4–301(a), in that settlement for returned checks is made under § 229.32(e), not by revocation of settlement.

B. 229.31(b) Expeditious Return of Checks

1. This section requires a paying bank (which, for purposes of subpart C, may include a payable-through and payable-at bank (see § 229.2(z)) that determines not to pay a check to return the check expeditiously. Section 229.31(c) sets forth exceptions to this general rule. If a paying bank is not subject to the requirement for expeditious return

under § 229.31(b), the paying bank, nonetheless, must return the check within its deadlines under the UCC, Regulation J (12 CFR part 210) or §§ 229.36(f)(3) and (f)(4), as extended by § 229.31(g), for returning the item or sending notice.

2. Two-day test

a. A returned check, including the original check, substitute check, or electronic returned check, is returned expeditiously if a paying bank sends the returned check in a manner such that the returned check would normally be received by the depositary bank not later than 2:00 p.m. (local time of the depositary bank) of the second business day following the banking day on which the check was presented to the paying bank.

b. A paying bank may satisfy its expeditious return requirement by returning either an electronic returned check or a paper check. For example, a paying bank could meet the expeditious return test by sending an electronic returned check directly to the depositary bank such that it normally would reach the depositary bank by the specified deadline, or sending an electronic returned check to a returning bank within the returning bank's timeframe for delivering electronic returned checks to the depositary bank within the return deadline. A paying bank that sends a returned check in paper form, even though it has an agreement to send electronic returned checks to the receiving bank, would typically need a highly expeditious means of delivery to meet the expeditious return test.

c. This test does not require actual receipt of the returned check by the depositary bank within the specified deadline. In determining whether an electronic returned check would normally reach a depositary bank within the specified deadline, a paying bank may rely on a returning bank's return deadlines and availability schedules for electronic

returned checks destined for the depositary bank. The paying bank is not responsible for unforeseeable delays in the return of the check, such as communication failures or transportation delays. A paying bank may not rely on the availability schedules if the paying bank has reason to believe that these schedules do not reflect the actual time for return of an electronic returned check to the depositary bank to which the paying bank is returning the check.

d. Where the second business day following presentment of the check to the paying bank is not a banking day for the depositary bank, the depositary bank may not process checks on that day. Consequently, if the last day of the time limit is not a banking day for the depositary bank, the check may be delivered to the depositary bank before the close of the depositary bank's next banking day and the return will still be considered expeditious.

3. Examples.

a. The paying bank and depositary bank have a bilateral agreement under which the depositary bank agrees to receive electronic returned checks directly from the paying bank. If a check is presented to a paying bank on Monday, the paying bank should send the returned check such that an electronic returned check normally would be received by the depositary bank by 2:00 p.m. (local time of the depositary bank) on Wednesday. This result is the same if, instead of a bilateral agreement, the paying bank and depositary bank are members of the same clearinghouse and agree to exchange electronic returned checks under clearinghouse rules.

b. i. The depositary bank has an agreement to receive electronic returned checks from Returning Bank A but not from the paying bank. The paying bank, however, has an

agreement with Returning Bank A to send electronic returned checks to Returning Bank A. If a check is presented to the paying bank on Monday, the paying bank should send the returned check such that the depositary bank normally would receive the returned check by 2:00 p.m. (local time of the depositary bank) on Wednesday. A paying bank may satisfy this requirement by sending either an electronic returned check or a paper returned check to Returning Bank A in a manner that permits Returning Bank A to send an electronic returned check to the depositary bank by 2:00 p.m. on Wednesday. The paying bank may also send a paper returned check to the depositary bank if a paper returned check would normally be received by the depositary bank by 2:00 p.m. on Wednesday.

ii. The paying bank has an agreement to send electronic returned checks to Returning Bank A. The depositary bank has an agreement to receive electronic returned checks from Returning Bank B. The paying bank does not have an agreement to send electronic returned checks to Returning Bank B. Returning Bank A, however, has an agreement to send electronic returned checks to Returning Bank B. Consequently, the paying bank, Returning Bank A, and Returning Bank B are subject to the expeditious return requirement. If a check is presented to the paying bank on Monday, the paying bank should send the returned check such that the depositary bank normally would receive the returned check by 2:00 p.m. (local time of the depositary bank) on Wednesday.

C. 229.31(c) Exceptions to the Expeditious Return Requirement

1. This paragraph sets forth the circumstances under which a paying bank is not required to return the check to the depositary bank in accordance with § 229.31(b).

2. *Example-- No direct or indirect electronic return agreement*. The paying bank has an agreement to send electronic returned checks to Returning Bank A. Returning Bank A, however, does not have an agreement to send electronic returned checks to the depositary bank or to any returning bank that has an agreement to send electronic returned checks to the depositary bank. Returning Bank A has not otherwise agreed to handle the returned check expeditiously. Consequently, Returning Bank A is not subject to the expeditious return requirement under § 229.32(b). Under these facts, the paying bank would not be subject to the expeditious return requirement under § 229.31(b). The paying bank, however, must comply with any deadlines under the UCC, Regulation J (12 CFR part 210), or § 229.30(e).

3. Depositary banks not subject to subpart B.

a. Subpart B of this regulation applies only to "checks" deposited in transaction "accounts." A depositary bank with only time or savings accounts need not comply with the availability requirements of subpart B of Regulation CC. Thus, the expedited return requirement of § 229.31(b) does not apply to checks being returned to banks that do not hold accounts. The paying bank's midnight deadline in UCC 4-301 and 4-302 and § 210.12 of Regulation J (12 CFR 210.12), and the extension in § 229.31(g), would continue to apply to these checks. Returning banks also would be required to exercise ordinary care when returning the checks (UCC 4-202).

b. The expeditious return requirement applies only to "checks" deposited in a bank that is a "depository institution" under the EFA Act. Federal Reserve Banks, Federal Home Loan Banks, private bankers, and possibly certain industrial banks are not "depository institutions" within the meaning of the EFA Act and therefore are not subject

to the expedited-availability requirements of subpart B of this regulation. Thus, the expedited return requirement of this section would not apply to a paying bank returning a check that was deposited in one of these banks.

4. Unidentifiable depositary bank

a. The sending of a check to a bank that handled the check for forward collection under this paragraph is not subject to the requirement for expeditious return by the paying bank. Although the lack of a requirement of expeditious return will create risks for the depositary bank, in many cases the inability to identify the depositary bank will be due to the depositary bank's, or a collecting bank's, failure to indorse as required by § 229.35(a). If the depositary bank failed to use the proper indorsement, it should bear the risks of less than expeditious return. Similarly, where the inability to identify the depositary bank is due to indorsements or other information placed on the back of the check by the depositary bank's customer or other prior indorser, the depositary bank should bear the risk that it cannot charge a returned check back to that customer.

b. This paragraph does not relieve a paying bank from the liability for the lack of expeditious return in cases where the paying bank is itself responsible for the inability to identify the depositary bank, such as when the paying bank's customer has used a check with printing or other material on the back in the area reserved for the depositary bank's indorsement, making the indorsement unreadable. (See § 229.38(c).)

c. A paying bank's return of a check to an unidentifiable depositary bank is subject to its midnight deadline under UCC 4–301, Regulation J (if the check is returned through a Federal Reserve Bank), and the extension provided in § 229.31(g).

(d) through (f) no change. * * * * *

D. 229.31(g) Extension of Deadline

1. This paragraph permits extension of the deadlines in the UCC, Regulation J (12 CFR part 210) and §§ 229.36(f)(3) and (f)(4) of this part for returning a check for which the paying bank previously has settled (generally midnight of the banking day following the banking day on which the check is received by the paying bank) and for returning a check without settling for it (generally midnight of the banking day on which the check is received by the paying bank, or such other time provided by § 210.9 of Regulation J (12 CFR part 210) or §§ 229.36(f)(3) or (f)(4) of this part), in two circumstances:

a. A paying bank may, by agreement, send an electronic returned check instead of a paper returned check or may have a courier that leaves after midnight (or after any other applicable deadline) to deliver its forward-collection checks. This paragraph removes the constraint of the midnight deadline for returned checks if the returned check reaches the depositary bank (or receiving bank, if the depositary bank is unidentifiable) on or before the depositary bank's (or receiving bank's) next banking day following the otherwise applicable deadline by the earlier of the close of that banking day or a cutoff hour of 2:00 p.m. (local time of the depositary bank or receiving bank) or later set by the depositary bank (or receiving bank) under UCC 4–108. This paragraph applies to the extension of all midnight deadlines except Saturday midnight deadlines (see the following paragraph).

b. A paying bank may observe a banking day, as defined in the applicable UCC, on a Saturday, which is not a business day and therefore not a banking day under Regulation CC. In such a case, the UCC deadline for returning checks received and

settled for on Friday, or for returning checks received on Saturday without settling for them, might require the bank to return the checks by midnight Saturday. However, the bank may not have its back-office operations staff available on Saturday to prepare and send the electronic returned checks, and the returning bank or depositary bank that would be receiving this electronic information may not have staff available to process it until Sunday night or Monday morning. This paragraph extends the midnight deadline if the returned checks reach the returning bank by a cut-off hour (usually on Sunday night or Monday morning) that permits processing during its next processing cycle or reach the depositary bank (or receiving bank) by the cut-off hour on its next banking day following the Saturday midnight deadline. This paragraph applies exclusively to the extension of Saturday midnight deadlines.

2. The time limits that are extended in each case are the paying bank's midnight deadline for returning a check for which it has already settled and the paying bank's deadline for returning a check without settling for it in UCC 4–301 and 4–302, §§ 210.9 and 210.12 of Regulation J (12 CFR 210.9 and 210.12), and § 229.36(f)(3) and (f)(4) of this part.

3. If the paying bank has an agreement to do so with the receiving bank, the paying bank may satisfy its midnight or other return deadline by sending an electronic returned check prior to the expiration of the deadline. The time when the electronic returned check is considered to be received by the depositary bank is determined by the agreement. The paying bank satisfies its midnight or other return deadline by dispatching paper returned checks to another bank by courier, including a courier under contract with the paying bank, prior to expiration of the deadline.

4. This paragraph directly affects UCC 4–301 and 4–302 and §§ 210.9 and 210.12 of Regulation J (12 CFR 210.9 and 210.12) to the extent that this paragraph applies by its terms, and may affect other provisions.

E. 229.31(h) Payable Through and Payable at Checks

1. For purposes of subpart C, the regulation defines a payable-through or payable-at bank (which could be designated the collectible-through or collectible-at bank) as a paying bank. The requirements of subpart C are imposed on a payable-through or payable-at bank and are based on the time of receipt of the forward collection check by the payable-through or payable-at bank. This provision is intended to speed the return of checks and receipt of notices of nonpayment for checks that are payable through or at a bank to the depositary bank.

2. A check sent for payment or collection to a payable-through or payable-at bank is not considered to be drawn on that bank for purposes of the midnight deadline provision of UCC 4–301.

F. 229.31(i) Reliance on Routing Number

1. Although § 229.35 requires that the depositary bank indorsement contain its nine-digit routing number, it is possible that a returned check will bear the routing number of the depositary bank in fractional, nine-digit, or other form. This paragraph permits a paying bank to rely on the routing number of the depositary bank as it appears on the check (in the depositary bank's indorsement) or in the electronic check sent pursuant to an agreement when the check, or electronic check, is received by the paying bank.

2. If there are inconsistent routing numbers, the paying bank may rely on any routing number designating the depositary bank. The paying bank is not required to resolve the inconsistency prior to processing the check. The paying bank remains subject to the requirement to act in good faith and use ordinary care under § 229.38(a).

25. Commentary XVIII.§ 229.32 is revised to read as follows:

XVIII . Section 229.32 Returning Bank's Responsibility for Return of Checks

Alternative 1 for paragraphs A through E

A. 229.32(a) Return of Checks

1. Routing of returned check.

a. Under § 229.32(a), the returning bank is authorized to route the returned check in a variety of ways:

i. It may send the returned check directly to the depositary bank by sending an electronic returned check directly to the depositary bank if the returning bank has an agreement with the depositary bank to do so, or by using a courier or other means of delivery; or

ii. It may send the returned check or electronic returned check to any returning bank agreeing to handle the returned check regardless of whether or not the returning bank handled the check for forward collection.

b. If the returning bank elects to send the returned check directly to the depositary bank, it is not required to send the check to the branch of the depositary bank that first handled the check. A paper returned check may be sent to the depositary bank at any physical location permitted under § 229.33(b).

2. Unidentifiable depositary bank.

a. Returning banks agreeing to handle checks for return to depositary banks under § 229. 32(a) are expected to be expert in identifying depositary bank indorsements. In the limited cases where the returning bank cannot identify the depositary bank, if the returning bank did not handle the check for forward collection, it may send the returned check to any collecting bank that handled the check for forward collection.

b. If, on the other hand, the retuning bank itself handled the check for forward collection, it may send the returned check to a collecting bank that was prior to it in the forward-collection process, which will be better able to identify the depositary bank. If there are no prior collecting banks, the returning bank must research the collection of the check and identify the depositary bank.

c. The returning bank's return of a check under this paragraph is subject to the requirement to use ordinary care under UCC 4–202(b). (See definition of returning bank in § 229.2(cc).)

d. As in the case of a paying bank returning a check under § 229.31(a)(2), a returning bank returning a check under § 229.32(a)(2) must advise the bank to which it sends the returned check that it is unable to identify the depositary bank. This advice must be conspicuous, such as a stamp on the check or a notice on the cash letter. The returned check may not be prepared as a qualified return. In the case of an electronic returned check, the advice requirement may be satisfied as agreed to by the parties.

3. A returning bank agrees to handle a returned check if it–

a. Publishes or distributes availability schedules for the return of returned checks and accepts the returned check for return;

b. Handles a returned check for return that it did not handle for forward collection;

c. Agrees with the paying bank or returning bank to handle electronic returned checks sent by that bank; or

d. Otherwise agrees to handle a returned check.

4. Cut-off hours. A returning bank may establish earlier cut-off hours for receipt of returned checks than for receipt of forward collection checks, but, unless the sending bank and returning bank agree otherwise, the cut-off hour for returned checks may not be earlier than 2:00 p.m. (local time of the returning bank). The returning bank also may set different sorting requirements for returned checks than those applicable to other checks. Thus, a returning bank may allow itself more processing time for returns than for forward collection checks.

5. Qualified returned checks.

a. A qualified returned check will be handled by subsequent returning banks more efficiently than a raw return. The qualified returned check must include the routing number of the depositary bank, the amount of the check, and a return identifier encoded on the check in magnetic ink. A check that is converted to a qualified returned check must be encoded in accordance with ANS X9.13 for original checks or ANS X9.100–140 for substitute checks. If the returning bank makes an encoding error in creating a qualified returned check, it may be liable under § 229.38 for losses caused by any negligence or under § 229.34(d)(3) for breach of an encoding warranty.

6. Responsibilities of returning bank. In meeting the requirements of this section, the returning bank is responsible for its own actions, but not those of the paying bank,

other returning banks, or the depositary bank. (See UCC 4–202(c) regarding the responsibility of collecting banks.)

7. UCC sections affected. Section 229.32 directly affects UCC Section 4-214(a) and may affect other sections or provisions (See UCC 4-202(b)). Section 4–214(a) is affected in that settlement for returned checks is made under § 229.32(e) and not by charge-back of provisional credit.

B. 229.32(d) Notice in Lieu of Return

1. This paragraph is similar to § 229.31(f) and authorizes a returning bank to originate a notice in lieu of return if the returned check is unavailable for return. Notice in lieu of return is permitted only when a bank does not have and cannot obtain possession of the check (or when the bank must retain possession of the check for protest) and does not have sufficient information to create a substitute check. (See the commentary to § 229.31(f).)

C. 229.32(e) Settlement

1. Under the UCC, a paying bank settles with a presenting bank after the check is presented to the paying bank. The paying bank may recover the settlement when the paying bank returns the check to the presenting bank. Under this regulation, however, the paying bank may return the check directly to the depositary bank or through returning banks that did not handle the check for forward collection. On these more efficient return paths, the paying bank does not recover the settlement made to the presenting bank. Thus, this paragraph requires the returning bank to settle for a returned check (either with the paying bank or another returning bank) in the same way that it would settle for a similar

check for forward collection. To achieve uniformity, this paragraph applies even if the returning bank handled the check for forward collection.

2. Any returning bank, including one that handled the check for forward collection, may provide availability for returned checks pursuant to an availability schedule as it does for forward collection checks. These settlements by returning banks, as well as settlements between banks made during the forward collection of a check, are considered final when made subject to any deferment of availability. (See § 229.36(d) and commentary to § 229.35(b).)

3. A returning bank may vary the settlement method it uses by agreement with paying banks or other returning banks. Special rules apply in the case of insolvency of banks. (See § 229.39.) If payment cannot be obtained from a depositary bank or returning bank because of its insolvency or otherwise, recovery can be had by returning banks, paying banks, and collecting banks from prior banks on this basis of the liability of prior banks under § 229.35(b).

4. This paragraph affects UCC 4–214(a) in that a paying bank or collecting bank does not ordinarily have a right to charge back against the bank from which it received the returned check, although it is entitled to settlement if it returns the returned check to that bank, and may affect other sections or provisions. Under § 229.36(d), a bank collecting a check remains liable to prior collecting banks and the depositary bank's customer under the UCC.

D. 229.32(f) Charges

1. This paragraph permits any returning bank, even one that handled the check for forward collection, to impose a fee on the paying bank or other returning bank for its

service in handling a returned check. Where a claim is made under § 229.35(b), the bank on which the claim is made is not authorized by this paragraph to impose a charge for taking up a check. This paragraph preempts state laws to the extent that these laws prevent returning banks from charging fees for handling returned checks.

E. 229.32(g) Reliance on Routing Number

1. This paragraph is similar to § 229.31(i) and permits a returning bank to rely on routing numbers appearing on a returned check such as routing numbers in the depositary bank's indorsement, or in the electronic returned check received by the returning bank pursuant to an agreement, or on qualified returned checks. (See the commentary to § 229.31(i).)

Alternative 2 for paragraphs A through E

A. 229.32(a) Return of Checks

1. Routing of returned check.

a. Under § 229.32(a), the returning bank is authorized to route the returned check in a variety of ways:

i. It may send the returned check directly to the depositary bank by sending an electronic returned check directly to the depositary bank if the returning bank has an agreement with the depositary bank to do so, or by using a courier or other means of delivery; or

ii. It may send the returned check or electronic returned check to any returning bank agreeing to handle the returned check regardless of whether or not the returning bank handled the check for forward collection.

b. If the returning bank elects to send the returned check directly to the depositary bank, it is not required to send the check to the branch of the depositary bank that first handled the check. A paper returned check may be sent to the depositary bank at any physical location permitted under § 229.33(b).

2. Unidentifiable depositary bank.

a. Returning banks agreeing to handle checks for return to depositary banks under § 229. 32(a) are expected to be expert in identifying depositary bank indorsements. In the limited cases where the returning bank cannot identify the depositary bank, if the returning bank did not handle the check for forward collection, it may send the returned check to any collecting bank that handled the check for forward collection.

b. If, on the other hand, the retuning bank itself handled the check for forward collection, it may send the returned check to a collecting bank that was prior to it in the forward-collection process, which will be better able to identify the depositary bank. If there are no prior collecting banks, the returning bank must research the collection of the check and identify the depositary bank.

c. The returning bank's return of a check under this paragraph is subject to the requirement to use ordinary care under UCC 4–202(b). (See definition of returning bank in § 229.2(cc).)

d. As in the case of a paying bank returning a check under § 229.31(a)(2), a returning bank returning a check under § 229.32(a)(2) must advise the bank to which it sends the returned check that it is unable to identify the depositary bank. This advice must be conspicuous, such as a stamp on the check or a notice on the cash letter. The

returned check may not be prepared as a qualified return. In the case of an electronic returned check, the advice requirement may be satisfied as agreed to by the parties.

3. A returning bank agrees to handle a returned check if it–

a. Publishes or distributes availability schedules for the return of returned checks and accepts the returned check for return;

b. Handles a returned check for return that it did not handle for forward collection;

c. Agrees with the paying bank or returning bank to handle electronic returned checks sent by that bank; or

d. Otherwise agrees to handle a returned check.

4. Cut-off hours. A returning bank may establish earlier cut-off hours for receipt of returned checks than for receipt of forward collection checks, but, unless the sending bank and returning bank agree otherwise, the cut-off hour for returned checks may not be earlier than 2:00 p.m. (local time of the returning bank). The returning bank also may set different sorting requirements for returned checks than those applicable to other checks. Thus, a returning bank may allow itself more processing time for returns than for forward collection checks.

5. Qualified returned checks.

a. A qualified returned check will be handled by subsequent returning banks more efficiently than a raw return. The qualified returned check must include the routing number of the depositary bank, the amount of the check, and a return identifier encoded on the check in magnetic ink. A check that is converted to a qualified returned check must be encoded in accordance with ANS X9.13 for original checks or ANS X9.100–140

for substitute checks. If the returning bank makes an encoding error in creating a qualified returned check, it may be liable under § 229.38 for losses caused by any negligence or under § 229.34(d)(3) for breach of an encoding warranty.

6. Responsibilities of returning bank. In meeting the requirements of this section, the returning bank is responsible for its own actions, but not those of the paying bank, other returning banks, or the depositary bank. (See UCC 4–202(c) regarding the responsibility of collecting banks.)

7. UCC sections affected. Section 229.32 directly affects UCC Section 4-214(a) and may affect other sections or provisions (See UCC 4-202(b)). Section 4–214(a) is affected in that settlement for returned checks is made under § 229.32(e) and not by charge-back of provisional credit.

B. 229.32(b) Expeditious Return of Checks

1. The standards for return of checks established by this section are similar to those for paying banks in § 229.31(b). This section requires a returning bank to return a returned check expeditiously, subject to the exceptions set forth in § 229.32(c). In effect, the returning bank is an agent or subagent of the paying bank and a subagent of the depositary bank for the purposes of returning the check.

2. A returning bank is subject to the expeditious return requirement with respect to a returned check if it–

a. Has an agreement to send electronic returned checks directly to the depositary bank, to another returning bank that has an agreement to send electronic returned checks to the depositary bank; or to another returning bank that otherwise agrees to handle the returned check expeditiously under § 229.32(b);

b. Publishes or distributes availability schedules for the expeditious return of returned checks to the depositary bank and accepts the returned check for return;

c. Agrees with the paying bank or returning bank to handle returned checks sent by that bank for expeditious return to certain depositary banks; or

d. Otherwise agrees to handle a returned check for expeditious return.

3. Two-day test. As in the case of a paying bank, a returning bank's return of a returned check is expeditious if it is sent in a manner such that the depositary bank would normally receive the returned check by 2:00 p.m. (local time of the depositary bank) of the second business day after the banking day on which the check was presented to the paying bank. Although a returning bank will not have firsthand knowledge of the day on which a check was presented to the paying bank, returning banks may, by agreement, allocate with paying banks liability for late return based on the delays caused by each.

4. *Example*. Returning Bank A does not have an agreement to send electronic returned checks to the depositary bank but has an agreement to send electronic returned checks to Returning Bank B, which, in turn, has an agreement to send electronic returned checks to the depositary bank. Under these facts, the returning bank would be subject to the expeditious return requirement under § 229.32(b). If a check is presented to the paying bank on Monday, the returning bank would need to send the returned check in a manner such that the depositary bank normally would receive the returned check by 2:00 p.m. (local time of the depositary bank) on Wednesday.

C. 229.32(c) Exceptions to the Expeditious Return Requirement

1. This paragraph sets forth the circumstances under which a returning bank is not required to return the check to the depositary bank in accordance with § 229.32(b).

2. *Example—No direct or indirect electronic return agreement.* The returning bank does not have an agreement to send electronic returned checks to the depositary bank. The returning bank also does not have an agreement to send electronic returned checks to any returning bank from which the depositary bank accepts electronic returned checks or to any returning bank that otherwise agrees to handle the return expeditious. Under these facts, the returning bank is not subject to the expeditious return requirement under § 229.32(b). The returning bank nonetheless is required to exercise ordinary care under UCC § 4-202 when returning checks. (See definition of returning bank in § 229.2(cc).)

3. Depositary bank not subject to subpart B. This paragraph is similar to § 229.31(c)(2) and relieves a returning bank of its obligation to make expeditious return to a depositary bank that does not hold "accounts" under subpart B of this regulation or is not a "depository institution" within the meaning of the EFT Act. (See the commentary to § 229.31(b).)

4. Unidentifiable depositary bank

As in the case of paying banks under § 229.31(c), a returning bank that cannot identify the depositary bank is not subject to the expeditious return requirements of § 229.32(b).

D. 229.32(f) Charges

1. This paragraph permits any returning bank, even one that handled the check for forward collection, to impose a fee on the paying bank or other returning bank for its service in handling a returned check. Where a claim is made under § 229.35(b), the bank on which the claim is made is not authorized by this paragraph to impose a charge for

taking up a check. This paragraph preempts state laws to the extent that these laws prevent returning banks from charging fees for handling returned checks.

E. 229.32(g) Reliance on Routing Number

1. This paragraph is similar to § 229.31(i) and permits a returning bank to rely on routing numbers appearing on a returned check such as routing numbers in the depositary bank's indorsement, or in the electronic returned check received by the returning bank pursuant to an agreement, or on qualified returned checks. (See the commentary to § 229.31(i).)

26. Commentary *XIX. Section 229.33* is revised to read as follows:

XIX. Section 229.33 Depositary Bank's Responsibility for Returned Checks and Notices of Nonpayment

Alternative 1 for paragraphs A through G

A. 229.33(a) Acceptance of Electronic Returned Checks and Electronic Notices of Nonpayment

1. A depositary bank may agree directly with a returning bank or a paying bank (or through clearinghouse rules) to accept electronic returned checks. Likewise, a depositary bank may agree directly with a paying bank (or through clearinghouse rules) to accept electronic written notices of nonpayment. (See §§ 229.2(ggg), 229.30(b), and 229.31(d) and commentary thereto.). The depositary bank's acceptance of electronic returned checks and electronic written notices of nonpayment is governed by the depositary bank's agreement with the banks sending the electronic returned check or electronic written notice of nonpayment to the depositary bank (or through the applicable clearinghouse rules). The agreement normally would specify the electronic address or receipt point at which the depositary bank accepts returned checks and written notices of

nonpayment electronically, as well as what constitutes receipt of the returned checks and written notices of nonpayment. The agreement also may specify whether electronic returned checks must be separated from electronic checks sent for forward collection.

B. 229.33(b) Acceptance of Paper Returned Checks and Paper Notices of Nonpayment

1. This paragraph states where the depositary bank is required to accept paper returned checks and paper notices of nonpayment during its banking day. (These locations differ from locations at which a depositary bank must accept oral notices or electronic notices. *See* § 229.33(c) and commentary thereto). This paragraph is derived from UCC 3–111, which specifies that presentment for payment may be made at the place specified in the instrument or, if there is none, at the place of business of the party to pay. In the case of returned checks, the depositary bank does not print the check and can only specify the place of "payment" of the returned check in its indorsement.

2. The paragraph specifies four locations at which the depositary bank must accept paper returned checks and paper notices of nonpayment:

a. The depositary bank must accept paper returned checks and paper notices of nonpayment at any location at which it requests presentment of forward collection paper checks, such as a processing center. A depositary bank does not request presentment of forward collection checks at a branch of the bank merely by paying checks presented over the counter.

b. i. If the depositary bank indorsement states the name and address of the depositary bank, it must accept paper returned checks and paper notices of nonpayment at the branch, head office, or other location, such as a processing center, indicated by the address. If the address is too general to identify a particular location, then the depositary

bank must accept paper returned checks and paper notices of nonpayment at any branch or head office consistent with the address. If, for example, the address is "New York, New York," each branch in New York City must accept paper returned checks and paper notices of nonpayment. Accordingly, a depositary bank may limit the locations at which it must accept paper returned checks and paper notices of nonpayment by specifying a branch or head office in its indorsement.

ii. If no address appears in the depositary bank's indorsement, the depositary bank must accept paper returned checks and paper notices of nonpayment at any branch or head office associated with the depositary bank's routing number. The offices associated with the routing number of a bank are found in *American Bankers Association Key to Routing Numbers*, published by an agent of the American Bankers Association, which lists a city and state address for each routing number.

iii. If no routing number or address appears in its indorsement, the depositary bank must accept a paper returned check at any branch or head office of the bank. Section 229.35 and applicable industry standards require that the indorsement contain a routing number, a name, and a location. Consequently paragraphs (b)(1)(ii)(B) and (C) of this section apply only where the depositary bank has failed to comply with the indorsement requirement.

3. For ease of processing, a depositary bank may require that returning banks or paying banks returning checks to it separate returned checks from forward collection checks being presented.

4. In general, banks may vary by agreement the location at which notices are received.

C. 229.33(c) Acceptance of Oral Notices of Nonpayment

1. In the case of telephone notices, the depositary bank may not refuse to accept notices at the telephone numbers identified in this section, but may transfer calls or use a recording device.

D. 229.33(d) Payment

1. As discussed in the commentary to § 229.32(e), under this regulation a paying bank or returning bank does not obtain credit for a returned check by charge-back but by, in effect, "presenting" the returned check to the depositary bank. This paragraph imposes an obligation to "pay" a returned check that is similar to the obligation to pay a forward collection check by a paying bank, except that the depositary bank may not return a returned check for which it is the depositary bank. Also, certain means of payment, such as remittance drafts, may be used only by agreement.

2. The depositary bank must pay for a returned check by the close of the banking day on which it received the returned check. The day on which a returned check is received is determined pursuant to UCC 4–108, which permits the bank to establish a cut-off hour, generally not earlier than 2:00 p.m. (local time of the depositary bank), and treat checks received after that hour as being received on the next banking day. If the depositary bank is unable to make payment to a returning bank or paying bank on the banking day that it receives the returned check, because the returning bank or paying bank is closed for a holiday or because the time when the depositary bank received the check is after the close of Fedwire, e.g., west coast banks with late cut-off hours, payment may be made on the next banking day of the bank receiving payment.

3. Payment must be made so that the funds are available for use by the bank returning the check to the depositary bank on the day the check is received by the depositary bank. For example, a depositary bank meets this requirement if it sends a wire transfer to the returning bank or paying bank on the day it receives the returned check, even if the returning bank or paying bank has closed for the day. A wire transfer should indicate the purpose of the payment.

4. The depositary bank may use a net settlement arrangement to settle for a returned check. Banks with net settlement agreements could net the appropriate credits and debits for returned checks with the accounting entries for forward collection checks if they so desired. If, for purposes of establishing additional controls or for other reasons, the banks involved desired a separate settlement for returned checks, a separate net settlement agreement could be established.

5. The bank sending the returned check to the depositary bank may agree to accept payment at a later date if, for example, it does not believe that the amount of the returned check or checks warrants the costs of same-day payment. Thus, a returning bank or paying bank may agree to accept payment through an ACH credit or debit transfer that settles the day after the returned check is received instead of a wire transfer that settles on the same day.

6. This paragraph and this subpart do not affect the depositary bank's right to recover a provisional settlement with its nonbank customer for a check that is returned. (See also §§ 229.19(c)(2)(ii), 229.33(g) and 229.35(b).)

E. 229.33(e) Misrouted Returned Checks and Written Notices of Nonpayment

1. This paragraph permits a bank receiving a check or written notice of nonpayment (either in paper form or electronic form) on the basis that it is the depositary bank to send the misrouted returned check or written notice of nonpayment to the correct depositary bank, if it can identify the correct depositary bank, either directly or through a returning bank agreeing to handle the check or written notice of nonpayment. When sending a returned check under this paragraph, the bank receiving the misrouted check is acting as a returning bank. Alternatively, the bank receiving the misrouted returned check or written notice of nonpayment must send the check or notice back to the bank from which it was received.

2. In sending a misrouted returned check, the bank to which the returned check was misrouted (the incorrect depositary bank) could receive settlement from the bank to which it sends the misrouted check under § 229.33(e) (the correct depositary bank, a returning bank that agrees to handle it, or the bank from which the misrouted check was received). The correct depositary bank would be required to pay for the returned check under § 229.33(d), and any other bank to which the check is sent under this paragraph would be required to settle for the check as a returning bank under § 229.32(e). The bank to which the returned check was misrouted is required to act promptly, i.e., within its midnight deadline. This paragraph does not affect a bank's duties under § 229.35(b).

F. 229.33(f) Charges

1. This paragraph prohibits a depositary bank from charging the equivalent of a presentment fee for returned checks. A returning bank, however, may charge a fee for handling returned checks. If the returning bank receives a mixed cash letter of returned checks, which includes some checks for which the returning bank also is the depositary

bank, the fee may be applied to all the returned checks in the cash letter. In the case of a sorted cash letter containing only returned checks for which the returning bank is the depositary bank, however, no fee may be charged.

G. 229.33(g) Notification to Customer

1. This paragraph requires a depositary bank to notify its customer of nonpayment upon receipt of a returned check or notice of nonpayment. . Notice also must be given if a depositary bank receives a notice of recovery under § 229.35(b). A bank that chooses to provide the notice required by § 229.33(g) in writing may send the notice by e-mail or facsimile if the bank sends the notice to the e-mail address or facsimile number specified by the customer for that purpose. The notice to the customer required under this paragraph also may satisfy the notice requirement of § 229.13(g) if the depositary bank invokes the reasonable-cause exception of § 229.13(e) due to the receipt of a notice of nonpayment, provided the notice meets all the requirements of § 229.13(g).

Alternative 2 for paragraphs A through G

A. 229.33(a) Acceptance of Electronic Returned Checks

The depositary bank's acceptance of electronic returned checks is governed by the depositary bank's agreement with the banks sending the electronic returned check or electronic written notice of nonpayment to the depositary bank (or through the applicable clearinghouse rules). The agreement normally would specify the electronic address or receipt point at which the depositary bank accepts returned checks electronically, as well as what constitutes receipt of the returned checks. The agreement also may specify whether electronic returned checks must be separated from electronic checks sent for forward collection.

B. 229.33(b) Acceptance of Paper Returned Checks

This paragraph states where the depositary bank is required to accept paper returned checks during its banking day. This paragraph is derived from UCC 3–111, which specifies that presentment for payment may be made at the place specified in the instrument or, if there is none, at the place of business of the party to pay. In the case of returned checks, the depositary bank does not print the check and can only specify the place of "payment" of the returned check in its indorsement.

2. The paragraph specifies four locations at which the depositary bank must accept paper returned checks:

a. The depositary bank must accept paper returned checks at any location at which it requests presentment of forward collection paper checks, such as a processing center. A depositary bank does not request presentment of forward collection checks at a branch of the bank merely by paying checks presented over the counter.

b. i. If the depositary bank indorsement states the name and address of the depositary bank, it must accept paper returned checks at the branch, head office, or other location, such as a processing center, indicated by the address. If the address is too general to identify a particular location, then the depositary bank must accept paper returned checks at any branch or head office consistent with the address. If, for example, the address is "New York, New York," each branch in New York City must accept paper returned checks. Accordingly, a depositary bank may limit the locations at which it must accept paper returned checks by specifying a branch or head office in its indorsement.

ii. If no address appears in the depositary bank's indorsement, the depositary bank must accept paper returned checks at any branch or head office associated with the

depositary bank's routing number. The offices associated with the routing number of a bank are found in *American Bankers Association Key to Routing Numbers*, published by an agent of the American Bankers Association, which lists a city and state address for each routing number.

iii. If no routing number or address appears in its indorsement, the depositary bank must accept a paper returned check at any branch or head office of the bank. Section 229.35 and applicable industry standards require that the indorsement contain a routing number, a name, and a location. Consequently paragraphs (b)(1)(ii)(B) and (C) of this section apply only where the depositary bank has failed to comply with the indorsement requirement.

3. For ease of processing, a depositary bank may require that returning banks or paying banks returning checks to it separate returned checks from forward collection checks being presented.

C. 229.33(d) Payment

1. As discussed in the commentary to § 229.32(c), under this regulation a paying bank or returning bank does not obtain credit for a returned check by charge-back but by, in effect, "presenting" the returned check to the depositary bank. This paragraph imposes an obligation to "pay" a returned check that is similar to the obligation to pay a forward collection check by a paying bank, except that the depositary bank may not return a returned check for which it is the depositary bank. Also, certain means of payment, such as remittance drafts, may be used only by agreement.

2. The depositary bank must pay for a returned check by the close of the banking day on which it received the returned check. The day on which a returned check is

received is determined pursuant to UCC 4–108, which permits the bank to establish a cut-off hour, generally not earlier than 2:00 p.m. (local time of the depositary bank), and treat checks received after that hour as being received on the next banking day. If the depositary bank is unable to make payment to a returning bank or paying bank on the banking day that it receives the returned check, because the returning bank or paying bank is closed for a holiday or because the time when the depositary bank received the check is after the close of Fedwire, e.g., west coast banks with late cut-off hours, payment may be made on the next banking day of the bank receiving payment.

3. Payment must be made so that the funds are available for use by the bank returning the check to the depositary bank on the day the check is received by the depositary bank. For example, a depositary bank meets this requirement if it sends a wire transfer to the returning bank or paying bank on the day it receives the returned check, even if the returning bank or paying bank has closed for the day. A wire transfer should indicate the purpose of the payment.

4. The depositary bank may use a net settlement arrangement to settle for a returned check. Banks with net settlement agreements could net the appropriate credits and debits for returned checks with the accounting entries for forward collection checks if they so desired. If, for purposes of establishing additional controls or for other reasons, the banks involved desired a separate settlement for returned checks, a separate net settlement agreement could be established.

5. The bank sending the returned check to the depositary bank may agree to accept payment at a later date if, for example, it does not believe that the amount of the returned check or checks warrants the costs of same-day payment. Thus, a returning bank

or paying bank may agree to accept payment through an ACH credit or debit transfer that settles the day after the returned check is received instead of a wire transfer that settles on the same day.

6. This paragraph and this subpart do not affect the depositary bank's right to recover a provisional settlement with its nonbank customer for a check that is returned. (See also §§ 229.19(c)(2)(ii), 229.33(g) and 229.35(b).)

E. 229.33(e) Misrouted Returned Checks

1. This paragraph permits a bank receiving a check (either in paper form or electronic form) on the basis that it is the depositary bank to send the misrouted returned check to the correct depositary bank, if it can identify the correct depositary bank, either directly or through a returning bank agreeing to handle the check. When sending a returned check under this paragraph, the bank receiving the misrouted check is acting as a returning bank. Alternatively, the bank receiving the misrouted returned check must send the check back to the bank from which it was received.

2. In sending a misrouted returned check, the bank to which the returned check was misrouted (the incorrect depositary bank) could receive settlement from the bank to which it sends the misrouted check under § 229.33(e) (the correct depositary bank, a returning bank that agrees to handle it, or the bank from which the misrouted check was received). The correct depositary bank would be required to pay for the returned check under § 229.33(d), and any other bank to which the check is sent under this paragraph would be required to settle for the check as a returning bank under § 229.32(e). The bank to which the returned check was misrouted is required to act promptly, i.e., within its midnight deadline. This paragraph does not affect a bank's duties under § 229.35(b).

F. 229.33(f) Charges

1. This paragraph prohibits a depositary bank from charging the equivalent of a presentment fee for returned checks. A returning bank, however, may charge a fee for handling returned checks. If the returning bank receives a mixed cash letter of returned checks, which includes some checks for which the returning bank also is the depositary bank, the fee may be applied to all the returned checks in the cash letter. In the case of a sorted cash letter containing only returned checks for which the returning bank is the depositary bank, however, no fee may be charged.

G. 229.33(g) Notification to Customer

1. This paragraph requires a depositary bank to notify its customer of nonpayment upon receipt of a returned check. Notice also must be given if a depositary bank receives a notice of recovery under § 229.35(b). A bank that chooses to provide the notice required by § 229.33(g) in writing may send the notice by e-mail or facsimile if the bank sends the notice to the e-mail address or facsimile number specified by the customer for that purpose.

27. Commentary *XX. Section 229.34*, is revised to read as follows:

XX. Section 229.34 Warranties and Indemnities

Alternative 1 for paragraphs A through K

A. 229.34(a) Warranties with respect to Electronic Checks and Electronic Returned Checks

1. Paragraph (a) sets forth the warranties that a bank makes when transferring or presenting an electronic check or electronic returned check and receiving settlement or other consideration for it. Electronic checks and electronic returned checks sent pursuant

to an agreement with the receiving bank are treated as checks subject to subpart C. Therefore, the warranties in § 229.34(a) are in addition to any warranties a bank makes under paragraphs (c), (d), (e), and (f) with respect to an electronic check or electronic returned check. For example, a bank that transfers and receives consideration for an electronic check that is derived from a remotely created check warrants that the remotely created check from which the electronic check is derived is authorized by the person on whose account the check is drawn.

2. The warranties in § 229.34(a)(1) relate to a subsequent bank's ability to create a substitute check. This paragraph provides a bank that creates a substitute check from an electronic check or electronic returned check with a warranty claim against any prior bank that transferred the electronic check or electronic returned check. The warranties in this paragraph correspond to the warranties made by a bank that transfers, presents, or returns a substitute check (a paper or electronic representation of a substitute check) for which it receives consideration. (*See* § 229.52 and commentary thereto). A bank that transfers an electronic check or electronic returned check that is an electronic representation of a substitute check also makes the warranties and indemnities in §§ 229.52 and 229.53.

3. By agreement, a sending and receiving bank may vary the warranties the sending bank makes to the receiving bank for electronic images of or electronic information related to checks, for example, to provide that the bank transferring the check does not warrant that the electronic image or information is sufficient for creating a substitute check. (See § 229.37(a)). The variation by agreement, however, would not affect the rights of banks and persons that are not bound by the agreement.

B. 229.34(b) Indemnity with Respect to an Electronic Image or Electronic Information Not Derived from a Paper Check

1. As a practical matter a bank receiving an electronic image generally cannot distinguish an image that is derived from a paper check from an image that was not derived from a paper check (an electronically-created item). Nonetheless, the bank receiving the electronically-created item often handles the electronically-created image as if it were derived from a paper check. The indemnity in § 229.34(b) enables a bank that receives the electronically-created item to be compensated for losses the bank incurs due to the fact that the electronic image was not derived from a paper check. (*See* § 229.34(i) and commentary thereto).

Examples.

a. A bank receives an electronic image of and electronic information related to an electronically-created item and, in turn, produces a paper item that is indistinguishable from a substitute check. The paper item is not a substitute check because the item is not derived from an original, paper check. That bank may incur a loss because it cannot produce the legal equivalent of a check (*See* § 229.53 and commentary thereto). The indemnity in § 229.34(b) enables a bank that received the electronically-created item to recover from the bank sending the check for the amount of the loss permitted under § 229.34(i).

b. A paying bank pays an electronically-created item, which the paying bank's customer subsequently claims is unauthorized. The paying bank may incur liability on the item due to the fact the item is electronically created and not derived from a paper check. For example, the paying bank may have no means of disputing the customer's

claim without examining the physical check, which does not exist. The indemnity in § 229.34(b) enables the paying bank to recover from the presenting bank or any prior transferor bank for the amount of its loss, as permitted under § 229.34(i), due to receiving the electronically-created item.

C. 229.34(c) Transfer and Presentment Warranties with respect to a Remotely Created Check

1. A bank that transfers or presents a remotely created check and receives a settlement or other consideration warrants that the person on whose account the check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check. The warranties are given only by banks and only to subsequent banks in the collection chain. The warranties ultimately shift liability for the loss created by an unauthorized remotely created check to the depositary bank. The depositary bank cannot assert the transfer and presentment warranties against a depositor. However, a depositary bank may, by agreement, allocate liability for such an item to the depositor and also may have a claim under other laws against that person.

2. The transfer and presentment warranties shift liability to the depositary bank only when the remotely created check is unauthorized, and would not apply when the customer initially authorizes a check but then experiences "buyer's remorse" and subsequently tries to revoke the authorization by asserting a claim against the paying bank under UCC 4–401. If the depositary bank suspects "buyer's remorse," it may obtain from its customer the express verifiable authorization of the check by the paying bank's customer and use that authorization as a defense to the warranty claim.

3. The scope of the transfer and presentment warranties for remotely created checks differs from that of the corresponding UCC warranty provisions in two respects. The UCC warranties differ from the § 229.34(c) warranties in that they are given by any person, including a nonbank depositor, that transfers a remotely created check and not just to a bank, as is the case under § 229.34(c). In addition, the UCC warranties state that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The § 229.34(c) warranties specifically cover the amount as well as the payee stated on the check. Neither the UCC warranties, nor the § 229.34(c) warranties, apply to the date stated on the remotely created check.

4. A bank making the § 229.34(c) warranties may defend a claim asserting violation of the warranties by proving that the customer of the paying bank is precluded by UCC 4–406 from making a claim against the paying bank. This may be the case, for example, if the customer failed to discover the unauthorized remotely created check in a timely manner.

5. The transfer and presentment warranties for a remotely created check apply to a remotely created check that has been converted to an electronic check or reconverted to a substitute check.

D. 229.34(d) Settlement Amount, Encoding, and Offset Warranties

1. Paragraph (d)(1) provides that a bank that presents and receives settlement for checks warrants to the paying bank that the settlement it demands (e.g., as noted on the cash letter or in the electronic cash letter file) equals the total amount of the checks it presents. This paragraph gives the paying bank a warranty claim against the presenting bank for the amount of any excess settlement made on the basis of the amount demanded,

plus expenses. If the amount demanded is understated, a paying bank discharges its settlement obligation under UCC 4–301 by paying the amount demanded, but remains liable for the amount by which the demand is understated; the presenting bank is nevertheless liable for expenses in resolving the adjustment.

2. When checks or returned checks are transferred to a collecting bank, returning bank, or depositary bank, the transferor bank is not required to demand settlement, as is required upon presentment to the paying bank. However, often the checks or returned checks will be accompanied by information (such as a cash letter listing or cash letter control record) that will indicate the total of the checks or returned checks. Paragraph (d)(2) provides that if the transferor bank includes information indicating the total amount of checks or returned checks transferred, it warrants that the information is correct (i.e., equals the actual total of the items).

3. Paragraph (d)(3) provides that a bank that presents or transfers a check or returned check warrants the accuracy of information encoded regarding the check after issue, and that exists at the time of presentment or transfer, to any bank that subsequently handles the check or returned check. Paragraph (d)(3) applies to all MICR-line encoding on a paper check, substitute check, or contained in an electronic check or electronic returned check. Under UCC 4–209(a), only the encoder (or the encoder and the depositary bank, if the encoder is a customer of the depositary bank) warrants the encoding accuracy, thus any claims on the warranty must be directed to the encoder. Paragraph (d)(3) expands on the UCC by providing that all banks that transfer or present a check or returned check make the encoding warranty. In addition, under the UCC, the

encoder makes the warranty to subsequent collecting banks and the paying bank, while paragraph (d)(3) provides that the warranty is made to banks in the return chain as well.

4. A paying bank that settles for an overstated cash letter because of a misencoded check may make a warranty claim against the presenting bank under paragraph (d)(1) (which would require the paying bank to show that the check was part of the overstated cash letter) or an encoding warranty claim under paragraph (d)(3) against the presenting bank or any preceding bank that handled the misencoded check.

5. Paragraph (d)(4) provides that a paying bank or a depositary bank may set off excess settlement paid to another bank against settlement owed to that bank for checks presented or returned checks received (for which it is the depositary bank) subsequent to the excess settlement.

E. 229.34(e) Returned Check Warranties

1. This paragraph includes warranties that a returned check, including a notice in lieu of return and electronic returned check, was returned by the paying bank, or in the case of a check payable by a bank and payable through another bank, the bank by which the check is payable, within the deadline under the UCC (subject to any claims or defenses under the UCC, such as breach of a presentment warranty) or § 229.31(e); that the paying bank or returning bank is authorized to return the check; that the returned check has not been materially altered; and that, in the case of a notice in lieu of return, the check has not been and will not be returned for payment. (See the commentary to § 229.31(f).) These warranties do not apply to checks drawn on the United States Treasury, to U.S. Postal Service money orders, or to checks drawn on a state or a unit of general local government that are not payable through or at a bank. (See § 229.42.)

F. 229.34(f) Notice of Nonpayment Warranties

1. This paragraph sets forth warranties for notices of nonpayment. This warranty does not include a warranty that the notice is accurate and timely under § 229.31(d). The requirements of § 229.31(d) that are not covered by the warranty are subject to the liability provisions of § 229.38. These warranties are designed to protect depositary banks that rely on notices of nonpayment. This paragraph imposes liability on a paying bank that gives notice of nonpayment and then subsequently returns the check. (See commentary on § 229.31(d).)

G. 229.34(g) Truncating Bank Indemnity

1. This indemnity provides for a depositary bank's potential liability when it permits a customer to truncate checks and deposit an electronic image of the original check instead of the original check. Because the depositary bank's customer retains the original check, that customer might, intentionally or mistakenly, deposit the original check in another depositary bank. The depositary bank that accepts the original check, in turn, may make funds available to the customer before it learns that the check is being returned unpaid and, in some cases, may be unable to recover the funds from its customer. Section 229.34(k) provides the depositary bank that accepts the original check for deposit with a claim against the depositary bank that permitted its customer to truncate the original check, did not receive the original check, receives settlement or other consideration for the check, and does not receive a return of the check unpaid. This claim exists only if the check is returned to the depositary bank that accepted the original check due to the fact that the check had already been paid.

Examples.

a. Depositary Bank A offers its customers a remote deposit capture service that permits customers to take pictures of the front and back of their checks and send the image to the bank for deposit. Depositary Bank A accepts an image of the check from its customer and sends an electronic check for collection to Paying Bank. Paying Bank, in turn, pays the check. Depositary Bank A receives settlement for the check. The same customer who sent Depositary Bank A the electronic image of the check then deposits the original check in Depositary Bank B. Depositary Bank B sends the original check (or a substitute check or electronic check) for collection and makes funds from the deposited check available to its customer. The customer withdraws the funds. Paying Bank returns the check to Depositary Bank B indicating that the check already had been paid. Depositary Bank B may be unable to charge back funds from its customer's account. Depositary Bank B may make an indemnity claim against Depositary Bank A for the amount of the funds Depositary Bank B is unable to recover from its customer.

b. The facts are the same as above with respect to Depositary Bank A; however, Depositary Bank B also offers a remote deposit capture service to its customer. The customer uses Depositary Bank B's remote deposit capture service to send an electronic image of the front and back of the check, after sending the same image to Depositary Bank A. The customer also deposits the original check into Depositary Bank C. Paying Bank pays the check based on the image presented by Depositary Bank A, and Depositary Bank A receives settlement for the check without the check being returned unpaid to it. Paying Bank returns the checks presented by Depositary Bank B and Depositary Bank C. Neither Depositary Bank B nor Depositary Bank C can recover the

funds from the deposited check from the customer. Depositary Bank B does not have an indemnity claim against Depositary Bank A because Depositary Bank B did not receive the original check for deposit. Depositary Bank C, however, would be able to bring an indemnity claim against Depositary Bank A or Depositary Bank B.

3. A depositary bank may, by agreement, allocate liability for loss incurred from subsequent deposit of the original check to its customer that sent the electronic check related to the original check to the depositary bank.

H. 229.34(h) Damages

1. This paragraph adopts for the warranties in § 229.34(a), (c), (d), (e), and (f) the damages provided in UCC 4–207(c) and 4A–506(b). (See definition of interest compensation in § 229.2(oo).)

I. 229.34(i) Indemnity Amounts

1. This paragraph adopts for the amount of the indemnities provided for in §§ 229.34(b) and (g) an amount comparable to the damages provided in § 229.53(b)(1)(ii) of subpart D of this regulation.

2. The amount of an indemnity would be reduced in proportion to the amount of any loss attributable to the indemnified person's negligence or bad faith. This comparative-negligence standard is intended to allocate liability in the same manner as the comparative negligence provision of § 229.38(c).

J. 229.34(j) Tender of Defense

1. This paragraph adopts for this regulation the vouching-in provisions of UCC 3–119.

K. 229.34(k) Notice of Claim

1. This paragraph adopts the notice provisions of UCC sections 4–207(d) and 4–208(e). The time limit set forth in this paragraph applies to notices of claims for warranty breaches and for indemnities. As provided in § 229.38(g), all actions under this section must be brought within one year after the date of the occurrence of the violation involved.

Alternative 2 for paragraphs A through J

A. 229.34(a) Warranties with respect to Electronic Checks and Electronic Returned Checks

1. Paragraph (a) sets forth the warranties that a bank makes when transferring or presenting an electronic check or electronic returned check and receiving settlement or other consideration for it. Electronic checks and electronic returned checks sent pursuant to an agreement with the receiving bank are treated as checks subject to subpart C. Therefore, the warranties in § 229.34(a) are in addition to any warranties a bank makes under paragraphs (c), (d), (e), and (f) with respect to an electronic check or electronic returned check. For example, a bank that transfers and receives consideration for an electronic check that is derived from a remotely created check warrants that the remotely created check from which the electronic check is derived is authorized by the person on whose account the check is drawn.

2. The warranties in § 229.34(a)(1) relate to a subsequent bank's ability to create a substitute check. This paragraph provides a bank that creates a substitute check from an electronic check or electronic returned check with a warranty claim against any prior bank that transferred the electronic check or electronic returned check. The warranties in this paragraph correspond to the warranties made by a bank that transfers, presents, or returns a substitute check (a paper or electronic representation of a substitute check) for

which it receives consideration. (*See* § 229.52 and commentary thereto). A bank that transfers an electronic check or electronic returned check that is an electronic representation of a substitute check also makes the warranties and indemnities in §§ 229.52 and 229.53.

3. By agreement, a sending and receiving bank may vary the warranties the sending bank makes to the receiving bank for electronic images of or electronic information related to checks, for example, to provide that the bank transferring the check does not warrant that the electronic image or information is sufficient for creating a substitute check. (See § 229.37(a)). The variation by agreement, however, would not affect the rights of banks and persons that are not bound by the agreement.

B. 229.34(b) Indemnity with Respect to an Electronic Image or Electronic Information Not Derived from a Paper Check

1. As a practical matter a bank receiving an electronic image generally cannot distinguish an image that is derived from a paper check from an image that was not derived from a paper check (an electronically-created item). Nonetheless, the bank receiving the electronically-created item often handles the electronically-created image as if it were derived from a paper check. The indemnity in § 229.34(b) enables a bank that receives the electronically-created item to be compensated for losses the bank incurs due to the fact that the electronic image was not derived from a paper check. (*See* § 229.34(i) and commentary thereto).

Examples.

a. A bank receives an electronic image of and electronic information related to an electronically-created item and, in turn, produces a paper item that is indistinguishable

from a substitute check. The paper item is not a substitute check because the item is not derived from an original, paper check. That bank may incur a loss because it cannot produce the legal equivalent of a check (*See* § 229.53 and commentary thereto). The indemnity in § 229.34(b) enables a bank that received the electronically-created item to recover from the bank sending the check for the amount of the loss permitted under § 229.34(i).

b. A paying bank pays an electronically-created item, which the paying bank's customer subsequently claims is unauthorized. The paying bank may incur liability on the item due to the fact the item is electronically created and not derived from a paper check. For example, the paying bank may have no means of disputing the customer's claim without examining the physical check, which does not exist. The indemnity in § 229.34(b) enables the paying bank to recover from the presenting bank or any prior transferor bank for the amount of its loss, as permitted under § 229.34(i), due to receiving the electronically-created item.

C. 229.34(c) Transfer and Presentment Warranties with respect to a Remotely Created Check

1. A bank that transfers or presents a remotely created check and receives a settlement or other consideration warrants that the person on whose account the check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check. The warranties are given only by banks and only to subsequent banks in the collection chain. The warranties ultimately shift liability for the loss created by an unauthorized remotely created check to the depositary bank. The depositary bank cannot assert the transfer and presentment warranties against a depositor. However, a

depositary bank may, by agreement, allocate liability for such an item to the depositor and also may have a claim under other laws against that person.

2. The transfer and presentment warranties shift liability to the depositary bank only when the remotely created check is unauthorized, and would not apply when the customer initially authorizes a check but then experiences "buyer's remorse" and subsequently tries to revoke the authorization by asserting a claim against the paying bank under UCC 4–401. If the depositary bank suspects "buyer's remorse," it may obtain from its customer the express verifiable authorization of the check by the paying bank's customer and use that authorization as a defense to the warranty claim.

3. The scope of the transfer and presentment warranties for remotely created checks differs from that of the corresponding UCC warranty provisions in two respects. The UCC warranties differ from the § 229.34(c) warranties in that they are given by any person, including a nonbank depositor, that transfers a remotely created check and not just to a bank, as is the case under § 229.34(c). In addition, the UCC warranties state that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The § 229.34(c) warranties specifically cover the amount as well as the payee stated on the check. Neither the UCC warranties, nor the § 229.34(c) warranties, apply to the date stated on the remotely created check.

4. A bank making the § 229.34(c) warranties may defend a claim asserting violation of the warranties by proving that the customer of the paying bank is precluded by UCC 4–406 from making a claim against the paying bank. This may be the case, for example, if the customer failed to discover the unauthorized remotely created check in a timely manner.

5. The transfer and presentment warranties for a remotely created check apply to a remotely created check that has been converted to an electronic check or reconverted to a substitute check.

D. 229.34(d) Settlement Amount, Encoding, and Offset Warranties

1. Paragraph (d)(1) provides that a bank that presents and receives settlement for checks warrants to the paying bank that the settlement it demands (e.g., as noted on the cash letter or in the electronic cash letter file) equals the total amount of the checks it presents. This paragraph gives the paying bank a warranty claim against the presenting bank for the amount of any excess settlement made on the basis of the amount demanded, plus expenses. If the amount demanded is understated, a paying bank discharges its settlement obligation under UCC 4–301 by paying the amount demanded, but remains liable for the amount by which the demand is understated; the presenting bank is nevertheless liable for expenses in resolving the adjustment.

2. When checks or returned checks are transferred to a collecting bank, returning bank, or depositary bank, the transferor bank is not required to demand settlement, as is required upon presentment to the paying bank. However, often the checks or returned checks will be accompanied by information (such as a cash letter listing or cash letter control record) that will indicate the total of the checks or returned checks. Paragraph (d)(2) provides that if the transferor bank includes information indicating the total amount of checks or returned checks transferred, it warrants that the information is correct (i.e., equals the actual total of the items).

3. Paragraph (d)(3) provides that a bank that presents or transfers a check or returned check warrants the accuracy of information encoded regarding the check after

issue, and that exists at the time of presentment or transfer, to any bank that subsequently handles the check or returned check. Paragraph (d)(3) applies to all MICR-line encoding on a paper check, substitute check, or contained in an electronic check or electronic returned check. Under UCC 4–209(a), only the encoder (or the encoder and the depositary bank, if the encoder is a customer of the depositary bank) warrants the encoding accuracy, thus any claims on the warranty must be directed to the encoder. Paragraph (d)(3) expands on the UCC by providing that all banks that transfer or present a check or returned check make the encoding warranty. In addition, under the UCC, the encoder makes the warranty to subsequent collecting banks and the paying bank, while paragraph (d)(3) provides that the warranty is made to banks in the return chain as well.

4. A paying bank that settles for an overstated cash letter because of a misencoded check may make a warranty claim against the presenting bank under paragraph (d)(1) (which would require the paying bank to show that the check was part of the overstated cash letter) or an encoding warranty claim under paragraph (d)(3) against the presenting bank or any preceding bank that handled the misencoded check.

5. Paragraph (d)(4) provides that a paying bank or a depositary bank may set off excess settlement paid to another bank against settlement owed to that bank for checks presented or returned checks received (for which it is the depositary bank) subsequent to the excess settlement.

E. 229.34(e) Returned Check Warranties

1. This paragraph includes warranties that a returned check, including a notice in lieu of return and electronic returned check, was returned by the paying bank, or in the case of a check payable by a bank and payable through another bank, the bank by which

the check is payable, within the deadline under the UCC (subject to any claims or defenses under the UCC, such as breach of a presentment warranty) or § 229.31(e); that the paying bank or returning bank is authorized to return the check; that the returned check has not been materially altered; and that, in the case of a notice in lieu of return, the check has not been and will not be returned for payment. (See the commentary to § 229.31(c).) These warranties do not apply to checks drawn on the United States Treasury, to U.S. Postal Service money orders, or to checks drawn on a state or a unit of general local government that are not payable through or at a bank. (See § 229.42.)

F. 229.34(g) Truncating Bank Indemnity

1. This indemnity provides for a depositary bank's potential liability when it permits a customer to truncate checks and deposit an electronic image of the original check instead of the original check. Because the depositary bank's customer retains the original check, that customer might, intentionally or mistakenly, deposit the original check in another depositary bank. The depositary bank that accepts the original check, in turn, may make funds available to the customer before it learns that the check is being returned unpaid and, in some cases, may be unable to recover the funds from its customer. Section 229.34(g) provides the depositary bank that accepts the original check for deposit with a claim against the depositary bank that permitted its customer to truncate the original check, did not receive the original check, receives settlement or other consideration for the check, and does not receive a return of the check unpaid. This claim exists only if the check is returned to the depositary bank that accepted the original check due to the fact that the check had already been paid.

Examples.

a. Depositary Bank A offers its customers a remote deposit capture service that permits customers to take pictures of the front and back of their checks and send the image to the bank for deposit. Depositary Bank A accepts an image of the check from its customer and sends an electronic check for collection to Paying Bank. Paying Bank, in turn, pays the check. Depositary Bank A receives settlement for the check. The same customer who sent Depositary Bank A the electronic image of the check then deposits the original check in Depositary Bank B. Depositary Bank B sends the original check (or a substitute check or electronic check) for collection and makes funds from the deposited check available to its customer. The customer withdraws the funds. Paying Bank returns the check to Depositary Bank B indicating that the check already had been paid. Depositary Bank B may be unable to charge back funds from its customer's account. Depositary Bank B may make an indemnity claim against Depositary Bank A for the amount of the funds Depositary Bank B is unable to recover from its customer.

b. The facts are the same as above with respect to Depositary Bank A; however, Depositary Bank B also offers a remote deposit capture service to its customer. The customer uses Depositary Bank B's remote deposit capture service to send an electronic image of the front and back of the check, after sending the same image to Depositary Bank A. The customer also deposits the original check into Depositary Bank C. Paying Bank pays the check based on the image presented by Depositary Bank A, and Depositary Bank A receives settlement for the check without the check being returned unpaid to it. Paying Bank returns the checks presented by Depositary Bank B and Depositary Bank C. Neither Depositary Bank B nor Depositary Bank C can recover the

funds from the deposited check from the customer. Depositary Bank B does not have an indemnity claim against Depositary Bank A because Depositary Bank B did not receive the original check for deposit. Depositary Bank C, however, would be able to bring an indemnity claim against Depositary Bank A or Depositary Bank B.

3. A depositary bank may, by agreement, allocate liability for loss incurred from subsequent deposit of the original check to its customer that sent the electronic check related to the original check to the depositary bank.

G. 229.34(h) Damages

1. This paragraph adopts for the warranties in § 229.34(a), (c), (d), (e), and (f) the damages provided in UCC 4–207(c) and 4A–506(b). (See definition of interest compensation in § 229.2(oo).)

H. 229.34(i) Indemnity Amounts

1. This paragraph adopts for the amount of the indemnities provided for in §§ 229.34(b) and (g) an amount comparable to the damages provided in § 229.53(b)(1)(ii) of subpart D of this regulation.

2. The amount of an indemnity would be reduced in proportion to the amount of any loss attributable to the indemnified person's negligence or bad faith. This comparative-negligence standard is intended to allocate liability in the same manner as the comparative negligence provision of § 229.38(c).

I. 229.34(j) Tender of Defense

1. This paragraph adopts for this regulation the vouching-in provisions of UCC 3–119.

J. 229.34(k) Notice of Claim

1. This paragraph adopts the notice provisions of UCC sections 4–207(d) and 4–208(e). The time limit set forth in this paragraph applies to notices of claims for warranty breaches and for indemnities. As provided in § 229.38(g), all actions under this section must be brought within one year after the date of the occurrence of the violation involved.

27. Commentary *XXI. Section 229.35 Indorsements* is revised to read as follows:

XXI. Section 229.35 Indorsements

A. 229.35(a) Indorsement Standards

1. This section requires banks to use a standard form of indorsement when indorsing checks during the forward collection and return process. It is designed to facilitate the identification of the depositary bank and the prompt return of checks. The indorsement standard a bank must use depends on the type of check being indorsed. A bank must indorse paper checks in accordance with ANS X9.100-111. At the time a reconverting bank creates a substitute check it must apply indorsements to the check in accordance with ANS X9.100-140. For electronic checks, banks must apply indorsements in accordance ANS X9.100-187. The Board, however, may by rule or order determine that different standards apply.

2. The parties sending and receiving a check may agree that different indorsement standards will apply to such checks. For example, although ANS X9.100-187 is an industry standard for banks' exchange of electronic checks, the parties may agree to send and receive electronic checks that conform to a different standard.

3. Banks generally apply indorsements to a paper check in one of two ways: (1) in accordance with ANS X9.100-111, banks print or "spray" indorsements onto a check when the check is processed through the banks' automated check sorters (regardless of

whether the checks are original checks or substitute checks), and (2) in accordance with ANS X9.100-140, reconverting banks print or "overlay" previously applied electronic indorsements and their own indorsements and identifications onto a substitute check at the time that the substitute check is created. If a subsequent substitute check is created in the course of collection or return, that substitute check will contain, in its image of the back of the previous substitute check, reproductions of indorsements that were sprayed or overlaid onto the previous item.

4. A bank might use check-processing equipment that captures an image of a check prior to spraying an indorsement onto that item. If the bank truncates that item, it should ensure that it also applies an indorsement to the item electronically. A reconverting bank satisfies its obligation to preserve all previously applied indorsements by overlaying a bank's indorsement that previously was applied electronically onto a substitute check that the reconverting bank creates. (See commentary to § 229.51(b)).

5. A depositary bank may want to include an address in its indorsement in order to limit the number of locations at which it must receive paper returned checks and paper notices of nonpayment. Banks should note, however, that § 229.33(b) requires a depositary bank to receive paper returned checks at the location(s) at which it receives paper forward-collection checks, as well as the other locations enumerated in § 229.33(b). (See § 229.33(b) and commentary thereto.)

6. Under the UCC, a specific guarantee of prior indorsement is not necessary. (See UCC 4–207(a) and 4–208(a).) Use of guarantee language in indorsements, such as "P.E.G." ("prior endorsements guaranteed"), may result in reducing the type size used in

bank indorsements, thereby making them more difficult to read. Use of this language may make it more difficult for other banks to identify the depositary bank.

7. If the bank maintaining the account into which a check is deposited agrees with another bank (a correspondent, ATM operator, or lock box operator) to have the other bank accept returns and notices of nonpayment for the bank of account, the indorsement placed on the check as the depositary bank indorsement may be the indorsement of the bank that acts as correspondent, ATM operator, or lock box operator as provided in paragraph (d) of this section.

8. In general, checks will be handled more efficiently if depositary banks design indorsement stamps so that the nine-digit routing number avoids pre-existing matter on the back of the check, for example, a carbon band. Indorsing parties other than banks, e.g., corporations, will benefit from the faster return of checks if they protect the identifiability and legibility of the depositary bank indorsement by staying clear of the area on the back of the check reserved for the depositary bank indorsement.

9. A paying bank is not required to indorse the check; however, if a paying bank does indorse a check that is returned, it should follow the indorsement standards for collecting banks and returning banks. Collecting banks and returning banks are required to indorse the check for tracing purposes. With respect to the identification of a paying bank that is also a reconverting bank, see the commentary to § 229.51(b)(2).

B. 229.35(b) Liability of Bank Handling Check

1. When a check is sent for forward collection, the collection process results in a chain of indorsements extending from the depositary bank through any subsequent collecting banks to the paying bank. This paragraph extends the indorsement chain

through the paying bank to the returning banks, and would permit each bank to recover from any prior indorser if the claimant bank does not receive payment for the check from a subsequent bank in the collection or return chain. For example, if a returning bank returned a check to an insolvent depositary bank, and did not receive the full amount of the check from the failed bank, the returning bank could obtain the unrecovered amount of the check from any bank prior to it in the collection and return chain including the paying bank. Because each bank in the collection and return chain could recover from a prior bank, any loss would fall on the first collecting bank that received the check from the depositary bank. To avoid circuity of actions, the returning bank could recover directly from the first collecting bank. Under the UCC, the first collecting bank might ultimately recover from the depositary bank's customer or from the other parties on the check.

2. Where a check is returned through the same banks used for the forward collection of the check, priority during the forward collection process controls over priority in the return process for the purpose of determining prior and subsequent banks under this regulation.

3. Where a returning bank is insolvent and fails to pay the paying bank or a prior returning bank for a returned check, § 229.39(a) requires the receiver of the failed bank to return the check to the bank that transferred the check to the failed bank. That bank then either could continue the return to the depositary bank or recover based on this paragraph. Where the paying bank is insolvent, and fails to pay the collecting bank, the collecting bank also could recover from a prior collecting bank under this paragraph, and the bank

from which it recovered could in turn recover from its prior collecting bank until the loss settled on the depositary bank (which could recover from its customer).

4. A bank is not required to make a claim against an insolvent bank before exercising its right to recovery under this paragraph. Recovery may be made by charge-back or by other means. This right of recovery also is permitted even where nonpayment of the check is the result of the claiming bank's negligence such as failure to make timely notice of nonpayment, but the claiming bank remains liable for its negligence under § 229.38.

5. This liability to a bank that subsequently handles the check and does not receive payment for the check is imposed on a bank handling a check for collection or return regardless of whether the bank's indorsement appears on the check. Notice must be sent under this paragraph to a prior bank from which recovery is sought reasonably promptly after a bank learns that it did not receive payment from another bank, and learns the identity of the prior bank. Written notice reasonably identifying the check and the basis for recovery is sufficient if the check is not available. Receipt of notice by the bank against which the claim is made is not a precondition to recovery by charge-back or other means; however, a bank may be liable for negligence for failure to provide timely notice. A paying bank or returning bank also may recover from a prior collecting bank as provided in §§ 229.31(g) and 229.32(e) (in those cases where the paying bank is unable to identify the depositary bank). This paragraph does not affect a paying bank's accountability for a check under UCC 4–215(a) and 4–302. Nor does this paragraph affect a collecting bank's accountability under UCC 4–213 and 4–215(d). A collecting bank becomes accountable upon receipt of final settlement as provided in the foregoing

UCC sections. Final settlement in §§ 229.32(e), 229.33(d), and 229.36(d) is intended to be consistent with final settlement in the UCC (e.g., UCC 4–213, 4–214, and 4–215). (See also § 229.2(cc) (definition of returning bank) and commentary thereto.)

6. This paragraph also provides that a bank may have the rights of a holder based on the handling of a check for collection or return. A bank may become a holder or a holder in due course regardless of whether prior banks have complied with the indorsement standard in § 229.35(a).

7. This paragraph affects the following provisions of the UCC, and may affect other provisions:

a. Section 4–214(a), in that the right to recovery is not based on provisional settlement, and recovery may be had from any prior bank. Section 4–214(a) would continue to permit a depositary bank to recover a provisional settlement from its customer. (See § 229.33(g).)

b. Section 3–415 and related provisions (such as section 3–503), in that such provisions would not apply as between banks, or as between the depositary bank and its customer.

C. 229.35(c) Indorsement by Bank

1. This section protects the rights of a customer depositing a check in a bank without requiring the words "pay any bank," as required by the UCC (See UCC 4–201(b).) Use of this language in a depositary bank's indorsement will make it more difficult for other banks to identify the depositary bank. The applicable industry standard prohibits such material in subsequent collecting bank indorsements. The existence of a

bank indorsement provides notice of the restrictive indorsement without any additional words.

D. 229.35(d) Indorsement for Depositary Bank

1. This section permits a depositary bank to arrange with another bank to indorse checks. This practice may occur when a correspondent indorses for a respondent, or when the bank servicing an ATM or lock box indorses for the bank maintaining the account in which the check is deposited—i.e., the depositary bank. If the indorsing bank applies the depositary bank's indorsement, checks will be returned to the depositary bank. An indorsing bank may by agreement with the depositary bank apply its own indorsement as the depositary bank indorsement. In that case, the depositary bank's own indorsement on the check (if any) should avoid the location reserved for the depositary bank. The actual depositary bank remains responsible for the availability and other requirements of subpart B, but the bank indorsing as depositary bank is considered the depositary bank for purposes of subpart C (e.g., for purposes of accepting paper checks under § 229.33(b)). The check will be returned, and notice of nonpayment will be given, to the bank indorsing as depositary bank.

2. Because the depositary bank for subpart B purposes will desire prompt notice of nonpayment, its arrangement with the indorsing bank should provide for prompt notice of nonpayment. The bank indorsing as depositary bank may require the depositary bank to agree to take up the check if the check is not paid even if the depositary bank's indorsement does not appear on the check and it did not handle the check. The arrangement between the banks may constitute an agreement varying the effect of provisions of subpart C under § 229.37.

28. Under Commentary XXII. *Section 229.36 Presentment and Issuance of Checks,*

A. Paragraph A. 229.36(a) *Receipt of Electronic Checks* is revised.

B. Paragraph B 229.36(b) *Receipt of Paper Checks* is revised.

C. Paragraph C 229.36(c) *Reserved* is removed.

D. Paragraph D 229.36(d) and Paragraph E 22.36(e) are redesignated as Paragraphs C 229.36(c) *Liability of Bank During Forward Collection,* and Paragraph D 229.36(d) 229.36(d) *Issuance of Payable Through Checks.*

E. Paragraph E 22.36(e) is reserved.

F. Paragraph F 22. 229.36(f) *Same-Day Settlement* is revised.

The revisions and redesignations read as follows:

XXII. Section 229.36 Presentment and Issuance of Checks

A. 229.36(a) Receipt of Electronic Checks

1. A paying bank may agree to accept presentment of electronic checks. (See § 229.2(ggg) and commentary thereto). The paying bank's acceptance of such electronic checks is governed by the paying bank's agreement with the bank sending the electronic item to the paying bank. The terms of these agreements are determined by the parties and may include, for example, the electronic address or electronic receipt point at which the paying bank agrees to accept electronic checks, as well as when presentment occurs. The agreement also may specify whether electronic checks sent for forward collection must be separated from electronic returned checks.

B. 229.36(b) Receipt of Paper Checks

1. The paragraph specifies four locations at which the paying bank must accept presentment of paper checks. Where the check is payable through a bank and the check is sent to that bank, the payable-through bank is the paying bank for purposes of this

subpart, regardless of whether the paying bank must present the check to another bank or to a nonbank payor for payment.

a. Delivery of checks may be made, and presentment is considered to occur, at a location (including a processing center) requested by the paying bank. This provision adopts the common law rule of a number of legal decisions that the processing center acts as the agent of the paying bank to accept presentment and to begin the time for processing of the check. (See also UCC 4–204(c).) If a bank designates different locations for the presentment of forward collection checks bearing different routing numbers, for purposes of this paragraph it requests presentment of checks bearing a particular routing number only at the location designated for receipt of forward collection checks bearing that routing number.

b. If the check specifies the name and address of a branch or head office, or other location (such as a processing center), the check may be delivered to that office or other location. If the address is too general to identify a particular office, delivery may be made at any office consistent with the address. For example, if the address is "San Francisco, California," each office in San Francisco must accept presentment. The designation of an address on the check generally is in the control of the paying bank.

c. i. Delivery may be made at an office of the bank associated with the routing number on the check. In the case of a substitute check, delivery may be made at an office of the bank associated with the routing number in the electronic check from which it was derived. The office associated with the routing number of a bank is found in *American Bankers Association Key to Routing Numbers,* published by an agent of the American Bankers Association, which lists a city and state address for each routing number. Checks

generally are handled by collecting banks on the basis of the nine-digit routing number contained in the MICR line (or on the basis of the fractional form routing number if the MICR line is obliterated) on the check, rather than the printed name or address. The definition of a paying bank in § 229.2(z) includes a bank designated by routing number, whether or not there is a name on the check, and whether or not any name is consistent with the routing number. Where a check is payable by one bank, but payable through another, the routing number is that of the payable-through bank, not that of the payor bank. In these cases, the payor bank has selected the payable-through bank as the point through which presentment is to be made.

ii. There is no requirement in the regulation that the name and address on the check agree with the address associated with the routing number on the check. A bank generally may control the use of its routing number, just as it does the use of its name. The address associated with the routing number may be a processing center.

iii. In some cases, a paying bank may have several offices in the city associated with the routing number. In such case, it would not be reasonable or efficient to require the presenting bank to sort the checks by more specific branch addresses that might be printed on the checks, and to deliver the checks to each branch. A collecting bank normally would deliver all checks to one location. In cases where checks are delivered to a branch other than the branch on which they may be drawn, computer and courier communication among branches should permit the paying bank to determine quickly whether to pay the check.

d. If the check specifies the name of the paying bank but no address, the bank must accept delivery at any office. Where delivery is made by a person other than a bank,

or where the routing number is not readable, delivery will be made based on the name and address of the paying bank on the check. If there is no address, delivery may be made at any office of the paying bank. This provision is consistent with UCC 3–111, which states that presentment for payment may be made at the place specified in the instrument, or, if there is none, at the place of business of the party to pay.

3. This paragraph may affect UCC 3–111 to the extent that the UCC requires presentment to occur at a place specified in the instrument.

C. 229.36(c) Liability of Bank During Forward Collection

1. This paragraph makes settlement between banks during forward collection final when made, subject to any deferment of credit, just as settlements between banks during the return of checks are final. In addition, this paragraph clarifies that this change does not affect the liability scheme under UCC 4–201 during forward collection of a check. That UCC section provides that, unless a contrary intent clearly appears, a bank is an agent or subagent of the owner of a check, but that Article 4 of the UCC applies even though a bank may have purchased an item and is the owner of it. This paragraph preserves the liability of a collecting bank to prior collecting banks and the depositary bank's customer for negligence during the forward collection of a check under the UCC, even though this paragraph provides that settlement between banks during forward collection is final rather than provisional. Settlement by a paying bank is not considered to be final payment for the purposes of UCC 4–215(a)(2) or (3), because a paying bank has the right to recover settlement from a returning bank or depositary bank to which it returns a check under this subpart. Other provisions of the UCC not superseded by this

subpart, such as section 4–202, also continue to apply to the forward collection of a check and may apply to the return of a check. (See definition of returning bank in § 229.2(cc).)

D. 229.36(d) Issuance of Payable Through Checks

E. 229.36(e) Reserved

F. 229.36(f) Same-Day Settlement

1. Section 229.36(d) governs settlement for presentment of paper checks. Settlement for presentment of electronic checks is governed by the agreement of the parties. (See § 229.36(a) and commentary thereto). This paragraph provides that, under certain conditions, a paying bank must settle with a presenting bank for a check on the same day the check is presented in order to avail itself of the ability to return the check on its next banking day under UCC 4–301 and 4–302. This paragraph does not apply to checks presented for immediate payment over the counter. Settling for a check under this paragraph does not constitute final payment of the check under the UCC This paragraph does not supersede or limit the rules governing collection and return of checks through Federal Reserve Banks that are contained in subpart A of Regulation J (12 CFR part 210).

2. Presentment requirements.

a. Location and time.

i. For presented checks to qualify for mandatory same-day settlement, information accompanying the checks must indicate that presentment is being made under this paragraph—e.g. "these checks are being presented for same-day settlement"—and must include a demand for payment of the total amount of the checks together with appropriate payment instructions in order to enable the paying bank to discharge its settlement responsibilities under this paragraph. In addition, the check or checks must be

presented at a location designated by the paying bank for receipt of checks for same-day settlement by 8:00 a.m. local time of that location. The designated presentment location must be a location at which the paying bank would be considered to have received a check under § 229.36(b). The paying bank may not designate a location solely for presentment of checks subject to settlement under this paragraph; by designating a location for the purposes of § 229.36(d), the paying bank agrees to accept checks at that location for the purposes of § 229.36(b).

ii. If the paying bank does not designate a presentment location, it must accept presentment for same-day settlement at any location identified in § 229.36(b), i.e., at an address of the bank associated with the routing number on the check, at any branch or head office if the bank is identified on the check by name without address, or at a branch, head office, or other location consistent with the name and address of the bank on the check if the bank is identified on the check by name and address. A paying bank and a presenting bank may agree that checks will be accepted for same-day settlement at an alternative location or that the cut-off time for same-day settlement be earlier or later than 8:00 a.m. local time of the presentment location.

iii. In the case of a check payable through a bank but payable by another bank, this paragraph does not authorize direct presentment to the bank by which the check is payable. The requirements of same-day settlement under this paragraph would apply to a payable-through or payable-at bank to which the check is sent for payment or collection.

b. Reasonable delivery requirements. A check is considered presented when it is delivered to and payment is demanded at a location specified in paragraph (d)(1). Ordinarily, a presenting bank will find it necessary to contact the paying bank to

determine the appropriate presentment location and any delivery instructions. Further, because presentment might not take place during the paying bank's banking day, a paying bank may establish reasonable delivery requirements to safeguard the checks presented, such as use of a night depository. If a presenting bank fails to follow reasonable delivery requirements established by the paying bank, it runs the risk that it will not have presented the checks. However, if no reasonable delivery requirements are established or if the paying bank does not make provisions for accepting delivery of checks during its non-business hours, leaving the checks at the presentment location constitutes effective presentment.

c. Sorting of checks. A paying bank may require that checks presented to it for same-day settlement be sorted separately from other forward collection checks it receives as a collecting bank or returned checks it receives as a returning bank or depositary bank. For example, if a bank provides correspondent check collection services and receives unsorted checks from a respondent bank that include checks for which it is the paying bank and that would otherwise meet the requirements for same-day settlement under this section, the collecting bank need not make settlement in accordance with paragraph (d)(3). If the collecting bank receives sorted checks from its respondent bank, consisting only of checks for which the collecting bank is the paying bank and that meet the requirements for same-day settlement under this paragraph, the collecting bank may not charge a fee for handling those checks and must make settlement in accordance with this paragraph.

3. Settlement

a. If a bank presents a check in accordance with the time and location requirements for presentment under paragraph (d)(1), the paying bank either must settle for the check on the business day it receives the check without charging a presentment fee or return the check prior to the time for settlement. (This return deadline is subject to extension under § 229.31(g).) The settlement must be in the form of a credit to an account designated by the presenting bank at a Federal Reserve Bank (e.g., a Fedwire transfer). The presenting bank may agree with the paying bank to accept settlement in another form (e.g., credit to an account of the presenting bank at the paying bank or debit to an account of the paying bank at the presenting bank). The settlement must occur by the close of Fedwire on the business day the check is received by the paying bank. Under the provisions of § 229.34(d), a settlement owed to a presenting bank may be set off by adjustments for previous settlements with the presenting bank. (See also § 229.39(d).)

b. Checks that are presented after the 8:00 a.m. (local time of the location at which the checks are presented) presentment deadline for same-day settlement and before the paying bank's cut-off hour are treated as if they were presented under other applicable law and settled for or returned accordingly. However, for purposes of settlement only, the presenting bank may require the paying bank to treat such checks as presented for same-day settlement on the next business day in lieu of accepting settlement by cash or other means on the business day the checks are presented to the paying bank. Checks presented after the paying bank's cut-off hour or on non-business days, but otherwise in accordance with this paragraph, are considered presented for same-day settlement on the next business day.

4. Closed Paying Bank

a. There may be certain business days that are not banking days for the paying bank. Some paying banks may continue to settle for checks presented on these days (e.g., by opening their back office operations). In other cases, a paying bank may be unable to settle for checks presented on a day it is closed. If the paying bank closes on a business day and checks are presented to the paying bank in accordance with paragraph (d)(1), the paying bank is accountable for the checks unless it settles for or returns the checks by the close of Fedwire on its next banking day. In addition, checks presented on a business day on which the paying bank is closed are considered received on the paying bank's next banking day for purposes of the UCC midnight deadline (UCC 4–301 and 4–302).

b. If the paying bank is closed on a business day voluntarily, the paying bank must pay interest compensation, as defined in § 229.2(oo), to the presenting bank for the value of the float associated with the check from the day of the voluntary closing until the day of settlement. Interest compensation is not required in the case of an involuntary closing on a business day, such as a closing required by state law. In addition, if the paying bank is closed on a business day due to emergency conditions, settlement delays and interest compensation may be excused under § 229.38(d) or UCC 4–109(b).

5. Good faith. Under § 229.38(a), both presenting banks and paying banks are held to a standard of good faith, defined in § 229.2(nn) to mean honesty in fact and the observance of reasonable commercial standards of fair dealing. For example, designating a presentment location or changing presentment locations for the primary purpose of discouraging banks from presenting checks for same-day settlement might not be considered good faith on the part of the paying bank. Similarly, presenting a large volume

of checks without prior notice could be viewed as not meeting reasonable commercial standards of fair dealing and therefore may not constitute presentment in good faith. In addition, if banks, in the general course of business, regularly agree to certain practices related to same-day settlement, it might not be considered consistent with reasonable commercial standards of fair dealing, and therefore might not be considered good faith, for a bank to refuse to agree to those practices if agreeing would not cause it harm.

6. UCC sections affected. This paragraph directly affects the following provisions of the UCC and may affect other sections or provisions:

a. Section 4–204(b)(1), in that a presenting bank may not send a check for same-day settlement directly to the paying bank, if the paying bank designates a different location in accordance with paragraph (d)(1).

b. Section 4–213(a), in that the medium of settlement for checks presented under this paragraph is limited to a credit to an account at a Federal Reserve Bank and that, for checks presented after the deadline for same-day settlement and before the paying bank's cut-off hour, the presenting bank may require settlement on the next business day in accordance with this paragraph rather than accept settlement on the business day of presentment by cash.

c. Section 4–301(a), in that, to preserve the ability to exercise deferred posting, the time limit specified in that section for settlement or return by a paying bank on the banking day a check is received is superseded by the requirement to settle for checks presented under this paragraph by the close of Fedwire.

d. Section 4–302(a), in that, to avoid accountability, the time limit specified in that section for settlement or return by a paying bank on the banking day a check is

received is superseded by the requirement to settle for checks presented under this paragraph by the close of Fedwire.

29. Commentary XXIV. Section 229.38 *Liability*, is revised to read as follows:

XXIV. Section 229.38 Liability

Alternative 1 for this section

A. 229.38(a) Standard of care; liability; measure of damages

1. The standard of care established by this section applies to any bank covered by the requirements of subpart C of the regulation. Thus, the standard of care applies to a paying bank under §§ 229.31, to a returning bank under § 229.32, to a depositary bank under §§ 229.33, to a bank erroneously receiving a returned check or written notice of nonpayment as depositary bank under § 229.33(e), and to a bank indorsing a check under § 229.35. The standard of care is similar to the standard imposed by UCC 1–203 and 4–103(a) and includes a duty to act in good faith, as defined in § 229.2(nn) of this regulation.

2. A bank not meeting this standard of care is liable to the depositary bank, the depositary bank's customer, the owner of the check, or another party to the check. The depositary bank's customer is usually a depositor of a check in the depositary bank (but see § 229.35(d)). The measure of damages provided in this section (loss incurred up to amount of check, less amount of loss party would have incurred even if bank had exercised ordinary care) is based on UCC 4–103(e) (amount of the item reduced by an amount that could not have been realized by the exercise of ordinary care), as limited by 4–202(c) (bank is liable only for its own negligence and not for actions of subsequent

banks in chain of collection). This subpart does not absolve a collecting bank of liability to prior collecting banks under UCC 4–201.

3. Under this measure of damages, a depositary bank or other person must show that the damage incurred results from the negligence proved. For example, the depositary bank may not simply claim that its customer will not accept a charge-back of a returned check, but must prove that it could not charge back when it received the returned check and could have charged back if no negligence had occurred, and must first attempt to collect from its customer. (See *Marcoux* v. *Van Wyk*, 572 F.2d 651 (8th Cir. 1978); *Appliance Buyers Credit Corp.* v. *Prospect Nat'l Bank,* 708 F.2d 290 (7th Cir. 1983).) Generally, a paying or returning bank's liability would not be reduced because the depositary bank did not place a hold on its customer's deposit before it learned of nonpayment of the check.

4. This paragraph also states that it does not affect a paying bank's liability to its customer. Under UCC 4–402, for example, a paying bank is liable to its customer for wrongful dishonor, which is different from failure to exercise ordinary care and has a different measure of damages.

B.229.38(c) Comparative negligence

1. This paragraph establishes a "pure" comparative negligence standard for liability under subpart C of this regulation. This comparative negligence rule may have particular application where a paying bank or returning bank delays in sending a notice of nonpayment because of difficulty in identifying the depositary bank. Some examples will illustrate liability in such cases. In each example, it is assumed that the returned check is received by the depositary bank after it has made funds available to its customer, that it

may no longer recover the funds from its customer, and that the inability to recover the funds from the customer is due to a delay in receiving notice of nonpayment of the check contrary to the standard established by § 229.31(d).

Examples.

a. If a depositary bank fails to use the indorsement required by this regulation, and this failure is caused by a failure to exercise ordinary care, and if a paying bank or returning bank is delayed in sending notice of nonpayment of the check because additional time is required to identify the depositary bank or find its routing number, the paying bank's liability to the depositary bank would be reduced or eliminated.

b. If the depositary bank uses the indorsement required by this regulation, but that indorsement is obscured by a subsequent collecting bank's indorsement, and a paying bank or returning bank is delayed in sending notice of nonpayment of the check because additional time was required to identify the depositary bank or find its routing number, the paying bank may not be liable to the depositary bank because the delay was not due to the paying bank's negligence. Nonetheless, the collecting bank may be liable to the depositary bank to the extent that its negligence in indorsing the check caused the paying bank's or returning bank's delay.

c. If a depositary bank accepts a check that has printing, a carbon band, or other material on the back of the check that existed at the time the check was issued, and the depositary bank's indorsement is obscured by the printing, carbon band, or other material, and a paying bank or returning bank is delayed in returning the check because additional time was required to identify the depositary bank, the returning bank may not be liable to the depositary bank because the delay was not due to its negligence.

Nonetheless, the paying bank may be liable to the depositary bank to the extent that the printing, carbon band, or other material caused the delay.

C. 229.38(d) Responsibility for Certain Aspects of Checks

1. Responsibility for back of check. The indorsement standards set forth in § 229.35 are most effective if the back of the check remains clear of other matter that may obscure bank indorsements. Because banks' indorsements are usually applied by automated systems without visual inspection of the back of the check or the related electronic image, it is not always practical to avoid pre-existing matter on the back of the check, for example, a carbon band or printed, stamped, or written terms or notations on the back of the check. Section 229.38(c) allocates responsibility for loss resulting from a delay in a notice of nonpayment due to indorsements that are not readable because of material on the back of the check.

2. The paying bank is responsible for loss resulting from a delay in a notice of nonpayment caused by indorsements that are not readable because of other material on the back of the check at the time that it was issued. For example, the backs of some checks bear pre-printed information or blacked out areas for various reasons. The payee of the check may, therefore, place its indorsement or other information in the area specified for the depositary bank indorsement, thus making the depositary bank indorsement unreadable. The depositary bank, by contrast, is responsible for a loss resulting from a delay in return caused by the condition of the check arising after its issuance until its acceptance by the depositary bank that made the depositary bank's indorsement illegible. Depositary banks and paying banks may shift these risks to their customers by agreement. (See § 229.37(a) and commentary thereto.)

3. ANS X9.100–140 provides that an image of an original check must be reduced in size when placed on the first substitute check associated with that original check. (The image thereafter would be constant in size on any subsequent substitute check that might be created.) Because of this size reduction, the location of an indorsement, particularly a depositary bank indorsement, applied to an original paper check likely will change when the first reconverting bank creates a substitute check that contains that indorsement within the image of the original paper check. If the indorsement was applied to the original paper check in accordance with ANS X9.100-111's location requirements for indorsements applied to existing paper checks, and if the size reduction of the image causes the placement of the indorsement to no longer be consistent with ANS X9.100-111's requirements, then the reconverting bank bears the liability for any loss that results from the shift in the placement of the indorsement. Such a loss could result either because the original indorsement applied in accordance with ANS X9.100-111 is rendered illegible by a subsequent indorsement that a reconverting bank later applies to the substitute check in accordance with ANS X9.100-140, or because a subsequent bank receiving a substitute check cannot apply its indorsement to the substitute check legibly in accordance with ANS X9.100-111 as a result of the shift in the previous indorsement.

Example.

A depositary bank sprays its indorsement onto a business-sized original check in a location specified in accordance with ANS X9.100-111. The check's conversion to electronic form and subsequent reconversion to paper form by the reconverting bank causes the location of the depositary bank indorsement, now contained within the image of the original check, to change such that it is closer to the leading edge of the substitute

check than it otherwise should be. A subsequent collecting bank sprays its indorsement onto the substitute check in accordance with ANS X9.100-111 and that location happens to be on top of the shifted depositary bank indorsement. If the check is returned unpaid and the notice of nonpayment is not received within the time requirements of § 229.31(d) because of the illegibility of the depositary bank indorsement, and the depositary bank incurs a loss that it would not have incurred had the notice of nonpayment been received in accordance with § 229.31(d), the reconverting bank bears the liability for that loss.

4. Responsibility under paragraph (c)(1) is treated as negligence for comparative negligence purposes, and the contribution to damages under paragraph (c)(1) is treated in the same way as the degree of negligence under paragraph (b) of this section.

D. 229.38(d) Timeliness of Action

1. This paragraph excuses certain delays. It adopts the standard of UCC 4–109(b).

E. 229.38(e) Exclusion

1. This paragraph provides that the civil liability and class action provisions, particularly the punitive damage provisions of sections 611(a) and (b), and the bona fide error provision of 611(c) of the EFA Act (12 U.S.C. 4010(a), (b), and (c)) do not apply to regulatory provisions adopted to improve the efficiency of the payments mechanism. Allowing punitive damages for delays in the return of checks where no actual damages are incurred would only encourage litigation and provide little or no benefit to the check collection system. In view of the provisions of paragraph (a), which incorporate traditional bank collection standards based on negligence, the provision on bona fide error is not included in subpart C.

F. 229.38(f) Jurisdiction

1. The EFA Act confers subject matter jurisdiction on courts of competent jurisdiction and provides a time limit for civil actions for violations of this subpart.

G. 229.38(g) Reliance on Board Rulings

1. This provision shields banks from civil liability if they act in good faith in reliance on any rule, regulation, or interpretation of the Board, even if it were subsequently determined to be invalid. Banks may rely on the commentary to this regulation, which is issued as an official Board interpretation, as well as on the regulation itself.

Alternative 2 for this section

A. 229.38(a) Standard of care; liability; measure of damages

1. The standard of care established by this section applies to any bank covered by the requirements of subpart C of the regulation. Thus, the standard of care applies to a paying bank under §§ 229.31, to a returning bank under § 229.32, to a depositary bank under §§ 229.33, to a bank erroneously receiving a returned check as depositary bank under § 229.33(e), and to a bank indorsing a check under § 229.35. The standard of care is similar to the standard imposed by UCC 1–203 and 4–103(a) and includes a duty to act in good faith, as defined in § 229.2(nn) of this regulation.

2. A bank not meeting this standard of care is liable to the depositary bank, the depositary bank's customer, the owner of the check, or another party to the check. The depositary bank's customer is usually a depositor of a check in the depositary bank (but see § 229.35(d)). The measure of damages provided in this section (loss incurred up to amount of check, less amount of loss party would have incurred even if bank had

exercised ordinary care) is based on UCC 4–103(e) (amount of the item reduced by an amount that could not have been realized by the exercise of ordinary care), as limited by 4–202(c) (bank is liable only for its own negligence and not for actions of subsequent banks in chain of collection). This subpart does not absolve a collecting bank of liability to prior collecting banks under UCC 4–201.

3. Under this measure of damages, a depositary bank or other person must show that the damage incurred results from the negligence proved. For example, the depositary bank may not simply claim that its customer will not accept a charge-back of a returned check, but must prove that it could not charge back when it received the returned check and could have charged back if no negligence had occurred, and must first attempt to collect from its customer. (See *Marcoux* v. *Van Wyk,* 572 F.2d 651 (8th Cir. 1978); *Appliance Buyers Credit Corp.* v. *Prospect Nat'l Bank,* 708 F.2d 290 (7th Cir. 1983).) Generally, a paying or returning bank's liability would not be reduced because the depositary bank did not place a hold on its customer's deposit before it learned of nonpayment of the check.

4. This paragraph also states that it does not affect a paying bank's liability to its customer. Under UCC 4–402, for example, a paying bank is liable to its customer for wrongful dishonor, which is different from failure to exercise ordinary care and has a different measure of damages.

B.229.38(c) Comparative negligence

1. This paragraph establishes a "pure" comparative negligence standard for liability under subpart C of this regulation.

c. If a depositary bank accepts a check that has printing, a carbon band, or other material on the back of the check that existed at the time the check was issued, and the depositary bank's indorsement is obscured by the printing, carbon band, or other material, and a paying bank or returning bank is delayed in returning the check because additional time was required to identify the depositary bank, the returning bank may not be liable to the depositary bank because the delay was not due to its negligence. Nonetheless, the paying bank may be liable to the depositary bank to the extent that the printing, carbon band, or other material caused the delay.

C. 229.38(d) Responsibility for Certain Aspects of Checks

1. Responsibility for back of check. The indorsement standards set forth in § 229.35 are most effective if the back of the check remains clear of other matter that may obscure bank indorsements. Because banks' indorsements are usually applied by automated systems without visual inspection of the back of the check or the related electronic image, it is not always practical to avoid pre-existing matter on the back of the check, for example, a carbon band or printed, stamped, or written terms or notations on the back of the check. 3. ANS X9.100–140 provides that an image of an original check must be reduced in size when placed on the first substitute check associated with that original check. (The image thereafter would be constant in size on any subsequent substitute check that might be created.) Because of this size reduction, the location of an indorsement, particularly a depositary bank indorsement, applied to an original paper check likely will change when the first reconverting bank creates a substitute check that contains that indorsement within the image of the original paper check. If the indorsement was applied to the original paper check in accordance with ANS X9.100-

111's location requirements for indorsements applied to existing paper checks, and if the size reduction of the image causes the placement of the indorsement to no longer be consistent with ANS X9.100-111's requirements, then the reconverting bank bears the liability for any loss that results from the shift in the placement of the indorsement. Such a loss could result either because the original indorsement applied in accordance with ANS X9.100-111 is rendered illegible by a subsequent indorsement that a reconverting bank later applies to the substitute check in accordance with ANS X9.100-140, or because a subsequent bank receiving a substitute check cannot apply its indorsement to the substitute check legibly in accordance with ANS X9.100-111 as a result of the shift in the previous indorsement.

4. Responsibility under paragraph (c)(1) is treated as negligence for comparative negligence purposes, and the contribution to damages under paragraph (c)(1) is treated in the same way as the degree of negligence under paragraph (b) of this section.

D. 229.38(d) Timeliness of Action

1. This paragraph excuses certain delays. It adopts the standard of UCC 4–109(b).

E. 229.38(e) Exclusion

1. This paragraph provides that the civil liability and class action provisions, particularly the punitive damage provisions of sections 611(a) and (b), and the bona fide error provision of 611(c) of the EFA Act (12 U.S.C. 4010(a), (b), and (c)) do not apply to regulatory provisions adopted to improve the efficiency of the payments mechanism. Allowing punitive damages for delays in the return of checks where no actual damages are incurred would only encourage litigation and provide little or no benefit to the check collection system. In view of the provisions of paragraph (a), which incorporate

traditional bank collection standards based on negligence, the provision on bona fide error is not included in subpart C.

F. 229.38(f) Jurisdiction

1. The EFA Act confers subject matter jurisdiction on courts of competent jurisdiction and provides a time limit for civil actions for violations of this subpart.

G. 229.38(g) Reliance on Board Rulings

1. This provision shields banks from civil liability if they act in good faith in reliance on any rule, regulation, or interpretation of the Board, even if it were subsequently determined to be invalid. Banks may rely on the commentary to this regulation, which is issued as an official Board interpretation, as well as on the regulation itself.

30. Commentary XXV. *Section 229.39 Insolvency of Bank,* is revised to read as follows:

XXV. Section 229.39 Insolvency of Bank

A. Introduction

1. These provisions cover situations where a bank becomes insolvent during collection or return. Paragraphs (a), (b), and (d) are derived from UCC 4–216. They are intended to apply to all banks. Like UCC 4-216, paragraphs (a), (b), and (d) of § 229.39 are intended to establish the point in the collection process at which collection or return of an item should be either stopped or continued when a particular bank suspends payments. Section 229.39(a) sets forth the circumstances under which the receiver must stop collection or return and, instead, send the check back to the bank or customer that transferred the check. Section 229.39(b) sets forth the circumstances under which the

collection or return of the item should continue. Paragraphs (a) and (b) of § 229.39 are not intended to confer upon banks preferential positions in the event of bank failures over general depositors or any other creditor of the failed bank. See UCC 4-216, cmt. 1.

B. 229.39(a) Duty of Receiver to Return Unpaid Checks

1. This paragraph requires a receiver of a closed bank to return a check to the prior bank if the paying bank or the receiver did not pay for the check. This permits the prior bank, as holder, to pursue its claims against the closed bank or prior indorsers on the check.

C. 229.39(b) Claims Against Banks for Checks Not Returned by the Receiver

1. This section sets forth the claims available to banks in situations in which a receiver does not return a check under § 229.39(a). In those situations, the prior bank would not be a holder of the check and would be unable to pursue claims as a holder.

2. Paragraph (b)(1) gives a bank a claim against a closed paying bank that finally pays a check without settling for it or a closed depositary bank that becomes obligated to pay a returned check without settling for it. If the bank with a claim under this paragraph recovers from a prior bank or other party to the check, the prior bank or other party to the check is subrogated to the claim.

3. Paragraph (b)(2) gives a bank a claim against a closed collecting bank, paying bank, or returning bank that receives settlement for but does not make settlement for a check. (See commentary to § 229.35(b) for discussion of prior and subsequent banks.) As in the case of § 229.39(b), if the bank with a claim under this paragraph recovers from a prior bank or other party to the check, the prior bank or other party to the check is subrogated to the claim.

D. 229.39(c) Preferred Claim Against Presenting Bank for Breach of Warranty

1. This paragraph gives a paying bank a preferred claim against a closed presenting bank in the event that the presenting bank breaches an amount or encoding warranty as provided in § 229.34(d)(1) or (3) and does not reimburse the paying bank for adjustments for a settlement made by the paying bank in excess of the value of the checks presented. This preferred claim is intended to have the effect of a perfected security interest and is intended to put the paying bank in the position of a secured creditor for purposes of the receivership provisions of the Federal Deposit Insurance Act and similar provisions of state law.

E. 229.39(d) Finality of Settlement

1. This paragraph provides that insolvency does not interfere with the finality of a settlement, such as a settlement by a paying bank that becomes final by expiration of the midnight deadline.

29. Commentary XXVI *Section 229.40 Effect on Merger Transaction*, is revised to read as follows:

XXVI. Section 229.40 Effect on Merger Transaction

A. When banks merge, there is normally a period of adjustment required before their operations are consolidated. To allow for this adjustment period, the regulation provides that the merged banks may be treated as separate banks for a period of up to one year after the consummation of the transaction. The term merger transaction is defined in § 229.2(t). This rule affects the status of the combined entity in a number of areas in this subpart. For example:

1. The paying bank's responsibility for notice of nonpayment (§ 229.31).
2. Where the depositary bank must accept returned checks (§ 229.33(b)).

3. Where the depositary bank must accept notice of nonpayment (§§ 229.33(b) and (c)).

4. Where a paying bank must accept presentment of checks (§ 229.36(b)).

31. Commentary XXVII. Section 229.41 *Relation to State Law* is revised to read as follows:

XXVII. Section 229.41 Relation to State Law

A. This section specifies that state law relating to the collection of checks is preempted only to the extent that it is inconsistent with this regulation. Thus, this regulation is not a complete replacement for state laws relating to the collection or return of checks.

32. Commentary XXVIII. Section 229.42 *Exclusions* is revised to read as follows:

XXVIII. Section 229.42 Exclusions

Alternative 1 for this section

Checks drawn on the United States Treasury, U.S. Postal Service money orders, and checks drawn on states and units of general local government that are presented directly to the state or unit of general local government and that are not payable through or at a bank are excluded from the coverage of the notice-of-nonpayment and same-day settlement requirements of subpart C of this part. Other provisions of this subpart continue to apply to the checks. This exclusion does not apply to checks drawn by the U.S. government on banks.

Alternative 2

A. Checks drawn on the United States Treasury, U.S. Postal Service money orders, and checks drawn on states and units of general local government that are presented directly to the state or unit of general local government and that are not payable through or at a bank are excluded from the coverage of the same-day settlement requirements of subpart

C of this part. Other provisions of this subpart continue to apply to the checks. This exclusion does not apply to checks drawn by the U.S. government on banks.

32. Commentary XXIX Section 229.43 *Checks Payable in Guam, American Samoa, and the Northern Mariana Islands,* are revised to read as follows:

XXIX. Section 229.43 Checks Payable in Guam, American Samoa, and the Northern Mariana Islands

A. 229.43(a) Definitions

1. For purposes of subparts B and C, bank offices in Guam, American Samoa, and the Northern Mariana Islands (which Regulation CC defines as Pacific island banks) do not meet the definition of bank in § 229.2(e) because they are not located in the United States. Some checks drawn on Pacific island banks (defined as Pacific island checks) bear U.S. routing numbers and are collected and returned by banks in the same manner as checks payable in the U.S.

Alternative 1 for paragraph B

B. 229.43(b) Rules Applicable to Pacific Island Checks

1. When a bank handles a Pacific island check as if it were a check as defined in § 229.2(k), the bank is subject to certain provisions of subpart C, as provided in this section. Because a Pacific island bank is not a bank as defined in § 229.2(e) for purposes of subpart C, it is not a paying bank as defined in § 229.2(z) for purposes of subpart C (unless otherwise noted in this section). Pacific island banks are not subject to the provisions of subparts B and C, but may be subject to the provisions of subpart D to the extent they create substitute checks. (See § 229.2(ff) defining "State").

2. A bank may agree to handle a Pacific island check as a returned check under § 229.32 and may convert the returned Pacific island check to a qualified returned check. The returning bank may receive the Pacific island check directly from a Pacific island bank or from another returning bank. As a Pacific island bank is not a paying bank for purposes of subpart C, § 229.32(e) does not apply to a returning bank settling with the Pacific island bank.

3. A depositary bank that handles a Pacific island check is not subject to the provisions of subpart B of Regulation CC, including the availability, notice, and interest accrual requirements, with respect to that check. If, however, a bank accepts a Pacific island check for deposit (or otherwise accepts the check as transferee) and collects the Pacific island check in the same manner as other checks, the bank generally is subject to the provisions of § 229.33, except for § 229.33(b) with respect to its application to notices of nonpayment, § 229.33(c) (acceptance of oral notices of nonpayment), and § 229.33(g) (notification to customer of returned check). If the depositary bank receives the returned Pacific island check directly from the Pacific island bank, the provisions of § 229.33(d) (regarding time and manner of settlement for returned checks) do not apply, because the Pacific island bank is not a paying bank for purposes of subpart C. In the event the Pacific island check is returned by a returning bank, however, the provisions of § 229.33(d) apply. The depositary bank is not subject to the provisions in § 229.33(b) with respect to notices of nonpayment for Pacific island checks, but is subject to § 229.33(b) with respect to returned checks that are Pacific island checks.

4. Banks that handle Pacific island checks in the same manner as other checks are subject to the indorsement provisions of § 229.35. Section 229.35(c) eliminates the need

for the restrictive indorsement "pay any bank." For purposes of § 229.35(c), the Pacific island bank is deemed to be a bank.

5. Pacific island checks will often be intermingled with other checks in a single cash letter. Therefore, a bank that handles Pacific island checks in the same manner as other checks is subject to the transfer warranty provision in § 229.34(d)(2) regarding accurate cash letter totals and the encoding warranty in § 229.34(d)(3). A bank that acts as a returning bank for a Pacific island check is not subject to the returned check warranties in § 229.34(e). Similarly, because the Pacific island bank is not a "bank" or a "paying bank" for purposes of subpart C, the notice of nonpayment warranties in § 229.34(f), and the presentment warranties in (c)(1) and (d)(4) do not apply. For the same reason, the provisions of § 229.36 governing paying bank responsibilities such as place of receipt and same-day settlement do not apply to checks presented to a Pacific island bank, and the liability provisions applicable to paying banks in § 229.38 do not apply to Pacific island banks. Section 229.36(d), regarding finality of settlement between banks during forward collection, applies to banks that handle Pacific island checks in the same manner as other checks, as do the liability provisions of § 229.38, to the extent the banks are subject to the requirements of Regulation CC as provided in this section, and §§ 229.37 and 229.39 through 229.42.

Alternative 2 for paragraph B

B. 229.43(b) Rules Applicable to Pacific Island Checks

1. When a bank handles a Pacific island check as if it were a check as defined in § 229.2(k), the bank is subject to certain provisions of subpart C, as provided in this section. Because a Pacific island bank is not a bank as defined in § 229.2(e) for purposes

of subpart C, it is not a paying bank as defined in § 229.2(z) for purposes of subpart C (unless otherwise noted in this section). Pacific island banks are not subject to the provisions of subparts B and C, but may be subject to the provisions of subpart D to the extent they create substitute checks. (See § 229.2(ff) defining "State").

2. A bank may agree to handle a Pacific island check as a returned check under § 229.32 and may convert the returned Pacific island check to a qualified returned check. The returning bank may receive the Pacific island check directly from a Pacific island bank or from another returning bank. As a Pacific island bank is not a paying bank for purposes of subpart C, § 229.32(e) does not apply to a returning bank settling with the Pacific island bank.

3. A depositary bank that handles a Pacific island check is not subject to the provisions of subpart B of Regulation CC, including the availability, notice, and interest accrual requirements, with respect to that check. If, however, a bank accepts a Pacific island check for deposit (or otherwise accepts the check as transferee) and collects the Pacific island check in the same manner as other checks, the bank generally is subject to the provisions of § 229.33, except for § 229.33(b) with respect to its application to notices of nonpayment, and § 229.33(g) (notification to customer of returned check). If the depositary bank receives the returned Pacific island check directly from the Pacific island bank, the provisions of § 229.33(d) (regarding time and manner of settlement for returned checks) do not apply, because the Pacific island bank is not a paying bank for purposes of subpart C. In the event the Pacific island check is returned by a returning bank, however, the provisions of § 229.33(d) apply. The depositary bank is not subject to the provisions in § 229.33(b) with respect to notices of nonpayment for Pacific island

checks, but is subject to § 229.33(b) with respect to returned checks that are Pacific island checks.

4. Banks that handle Pacific island checks in the same manner as other checks are subject to the indorsement provisions of § 229.35. Section 229.35(c) eliminates the need for the restrictive indorsement "pay any bank." For purposes of § 229.35(c), the Pacific island bank is deemed to be a bank.

5. Pacific island checks will often be intermingled with other checks in a single cash letter. Therefore, a bank that handles Pacific island checks in the same manner as other checks is subject to the transfer warranty provision in § 229.34(d)(2) regarding accurate cash letter totals and the encoding warranty in § 229.34(d)(3). A bank that acts as a returning bank for a Pacific island check is not subject to the returned check warranties in § 229.34(e). Similarly, because the Pacific island bank is not a "bank" or a "paying bank" for purposes of subpart C, the notice of nonpayment warranties in § 229.34(f), and the presentment warranties in (c)(1) and (d)(4) do not apply. For the same reason, the provisions of § 229.36 governing paying bank responsibilities such as place of receipt and same-day settlement do not apply to checks presented to a Pacific island bank, and the liability provisions applicable to paying banks in § 229.38 do not apply to Pacific island banks. Section 229.36(d), regarding finality of settlement between banks during forward collection, applies to banks that handle Pacific island checks in the same manner as other checks, as do the liability provisions of § 229.38, to the extent the banks are subject to the requirements of Regulation CC as provided in this section, and §§ 229.37 and 229.39 through 229.42.

33. Commentary *XXX. §229.51 General provisions governing substitute checks*, is revised to read as follows:

XXX. Section 229.51 General Provisions Governing Substitute Checks

A. §229.51(a) Legal Equivalence

1. * * * *

B. 229.51(b) Reconverting-Bank Duties

1. In accordance with ANS X9.100-140, a reconverting bank must indorse (or, if it is a paying bank with respect to the check or a bank that rejected a check submitted for deposit, identify itself on) the back of a substitute check in a manner that preserves all indorsements applied, whether physically or electronically, by persons that previously handled the check in any form for forward collection or return. Indorsements applied physically to the original check before an image of the check was captured would be preserved through the image of the back of the original check that a substitute check must contain. If a bank sprays an indorsement onto a paper check *after* it captures an image of the check, it should ensure that it applies an indorsement to the item electronically, if it transfers the check as an electronic check or electronic returned check. (See paragraph 4 of the commentary to section 229.35(a).) A reconverting bank satisfies its obligation to preserve all previously applied indorsements by physically applying (overlaying) electronic indorsements onto a substitute check that the reconverting bank creates. A reconverting bank is not responsible for obtaining indorsements that persons that previously handled the check in any form should have applied but did not apply.

2. A reconverting bank must identify itself and the truncating bank by applying its routing number and the routing number of the truncating bank to the front of a substitute check in accordance ANS X9.100–140.

3. If the reconverting bank is the paying bank or a bank that rejected a check submitted for deposit, it also must identify itself by applying its routing number to the back of the check. A reconverting bank also must preserve on the back of the substitute check, in accordance with ANS X9.100-140, the identifications of any previous reconverting banks. The reconverting-bank and truncating-bank routing numbers on the front of a substitute check and, if the reconverting bank is the paying bank or a bank that rejected a check submitted for deposit, the reconverting bank's routing number on the back of a substitute check are for identification only and are not indorsements or acceptances.

Example

A bank's customer, which is a nonbank business, receives checks for payment and by agreement deposits substitute checks instead of the original checks with its depositary bank. The depositary bank is the reconverting bank with respect to the substitute checks and the truncating bank with respect to the original checks. In accordance with ANS X9.100-140, the bank must therefore be identified on the front of the substitute checks as a reconverting bank and as the truncating bank, and on the back of the substitute checks as the depositary bank and a reconverting bank.

4. The location of an indorsement applied to a paper check in accordance with ANS X9.100-111 may shift if that check is truncated and later reconverted to a substitute check. If an indorsement applied to an original check in accordance with ANS X9.100-

111 is overwritten by a subsequent indorsement applied to a substitute check in accordance with industry standards, then one or both of those indorsements could be rendered illegible. As explained in § 229.38(c) and the commentary thereto, a reconverting bank is liable for losses associated with indorsements that are rendered illegible as a result of check substitution.

C. 229.51(c) Applicable Law

1. * * *

2. * * *

34. Commentary XXXI. *§229.52 Substitute Check Warranties,* is revised to read as follows:

XXXI. Section 229.52 Substitute Check Warranties

A. 229.52(a) Warranty Content and Provision

1. The responsibility for providing the substitute-check warranties begins with the reconverting bank. In the case of a substitute check created by a bank, the reconverting bank starts the flow of warranties when it transfers, presents, or returns a substitute check for which it receives consideration or when it rejects a check submitted for deposit and returns to its customer a substitute check. A bank that receives a substitute check created by a nonbank starts the flow of warranties when it transfers, presents, or returns for consideration either the substitute check it received or an electronic or paper representation of that substitute check.

2. To ensure that warranty protections flow all the way through to the ultimate recipient of a substitute check or paper or electronic representation thereof, any subsequent bank that transfers, presents, or returns for consideration either the substitute

check or a paper or electronic representation of the substitute check is responsible to subsequent transferees for the warranties. Any warranty recipient could bring a claim for a breach of a substitute-check warranty if it received either the actual substitute check or a paper or electronic representation of a substitute check.

3. The substitute-check warranties and indemnity are not given under sections 229.52 and 229.53 by a bank that truncates the original check and by agreement transfers an electronic check to a subsequent bank for consideration. However, parties may, by agreement, allocate liabilities associated with the exchange of electronic check information. A bank that is a truncating bank under § 229.2(eee)(2) because it accepts a deposit of a check electronically might be subject to a claim by another depositary bank that accepts the original check for deposit. (See § 229.34(g) and commentary thereto).

Example.

A bank that receives check information electronically and uses it to create substitute checks is the reconverting bank and, when it transfers, presents, or returns that substitute check, becomes the first warrantor. However, that bank may protect itself by including in its agreement with the sending bank provisions that specify the sending bank's warranties and responsibilities to the receiving bank, particularly with respect to the accuracy of the check image and check data transmitted under the agreement.

4. A bank need not affirmatively make the warranties because they attach automatically when a bank transfers, presents, or returns the substitute check (or a representation thereof) for which it receives consideration. Because a substitute check transferred, presented, or returned for consideration is warranted to be the legal equivalent of the original check and thereby subject to existing laws as if it were the

original check, all UCC and other Regulation CC warranties that apply to the original check also apply to the substitute check.

5. The legal-equivalence warranty by definition must be linked to a particular substitute check. When an original check is truncated, the check may move from electronic form to substitute-check form and then back again, such that there would be multiple substitute checks associated with one original check. When a check changes form multiple times in the collection or return process, the first reconverting bank and subsequent banks that transfer, present, or return the first substitute check (or a paper or electronic representation of the first substitute check) warrant the legal equivalence of only the first substitute check. If a bank receives an electronic representation of a substitute check and uses that representation to create a second substitute check, the second reconverting bank and subsequent transferees of the second substitute check (or a representation thereof) warrant the legal equivalence of both the first and second substitute checks. A reconverting bank would not be liable for a warranty breach under section 229.52 if the legal-equivalence defect is the fault of a subsequent bank that handled the substitute check, either as a substitute check or in other paper or electronic form.

6. The warranty in section 229.52(a)(1)(ii), which addresses multiple payment requests for the same check, is not linked to a particular substitute check but rather is given by each bank handling the substitute check, an electronic representation of a substitute check, or a subsequent substitute check created from an electronic representation of a substitute check. All banks that transfer, present, or return a substitute check (or a paper or electronic representation thereof) therefore provide the warranty

regardless of whether the ultimate demand for double payment is based on the original check, the substitute check, or some other electronic or paper representation of the substitute or original check, and regardless of the order in which the duplicative payment requests occur. This warranty is given by the banks that transfer, present, or return a substitute check even if the demand for duplicative payment results from a fraudulent substitute check about which the warranting bank had no knowledge. (See also section 229.34(a)(1)(ii).)

Example.

A nonbank depositor truncates a check and in lieu of the check sends an electronic check check to both Bank A and Bank B. Bank A and Bank B each use the check information that it received electronically to create a substitute check, which it presents to Bank C for payment. Bank A and Bank B are both reconverting banks and each made the substitute-check warranties when it presented a substitute check to and received payment from Bank C. Bank C could pursue a warranty claim for the loss it suffered as a result of the duplicative payment against either Bank A or Bank B.

7. A bank that rejects a check submitted for deposit and, instead of the original check, provides its customer with a substitute check makes the warranties in § 229.52(a)(1). As noted in the commentary to § 229.2(ccc), the Check 21 Act contemplates that nonbank persons that receive substitute checks (or representations thereof) from a bank will receive warranties and indemnities with respect to the checks. A reconverting bank that provides a substitute check to its depositor after it has rejected the check submitted for deposit may not have received consideration for the substitute check. In order to prevent banks from being able to transfer a check the bank truncated

and then reconverted without providing substitute check warranties, the regulation provides that a bank that rejects a check submitted for deposit but provides its customer with a substitute check (or a paper or electronic representation of a substitute check) makes the warranties set forth in § 229.52(a)(1) regardless of whether the bank received consideration.

Example.

A bank's customer submits a check for deposit at an ATM that captures an image of the check and sends the image electronically to the bank. After reviewing the item, the bank rejects the item submitted for deposit. Instead of providing the original check to its customer, the bank provides a substitute check to its customer. This bank is the reconverting bank with respect to the substitute check and makes the warranties described in § 229.52(a)(1) regardless of whether the bank previously extended credit to its customer. (See commentary to § 229.2(ccc).)

B. 229.52(b) Warranty Recipients

1. * * * *

2. The warranties flow with the substitute check to persons that receive a substitute check or a paper or electronic representation of a substitute check. The warranties do not flow to a person that receives only the original check or a representation of an original check that was not derived from a substitute check. However, a person that initially handled only the original check could become a warranty recipient if that person later receives a returned substitute check or a paper or electronic representation of a substitute check that was derived from that original check. (See §

229.34(g) regarding claims by a depositary bank that accepts deposit of an original check).

3. A reconverting bank also makes the warranties to a person to whom the bank transfers a substitute check that the bank has rejected for deposit regardless of whether the bank received consideration.

35. Commentary *XXXII. §229.53 Substitute Check Indemnity* is revised to read as follows:

XXXII. Section 229.53 Substitute Check Indemnity

A. 229.53(a) Scope of Indemnity

1. Each bank that for consideration transfers, presents, or returns a substitute check or a paper or electronic representation of a substitute check is responsible for providing the substitute-check indemnity.

2. The indemnity covers losses due to any subsequent recipient's receipt of the substitute check instead of the original check. The indemnity therefore covers the loss caused by receipt of the substitute check as well as the loss that a bank incurs because it pays an indemnity to another person. A bank that pays an indemnity would in turn have an indemnity claim regardless of whether it received the substitute check or a paper or electronic representation of the substitute check The indemnity would not apply to a person that handled only the original check or a paper or electronic image of the original check that was not derived from a substitute check.

3. A reconverting bank also provides the substitute check indemnity to a person to whom the bank transfers a substitute check (or a paper or electronic representation of a

substitute check) related to a check that the bank has rejected for deposit regardless of whether the bank providing the indemnity has received consideration.

B. 229.53(b) Indemnity Amount

1. If a recipient of a substitute check is making an indemnity claim because a bank has breached one of the substitute-check warranties, the recipient can recover any losses proximately caused by that warranty breach.

Examples.

a. A drawer discovers that its account has been charged for two different substitute checks that were provided to the drawer and that were associated with the same original check. As a result of this duplicative charge, the paying bank dishonored several subsequently presented checks that it otherwise would have paid and charged the drawer returned-check fees. The payees of the returned checks also charged the drawer returned-check fees. The drawer would have a warranty claim against any of the warranting banks, including its bank, for breach of the warranty described in section 229.52(a)(1)(ii). The drawer also could assert an indemnity claim. Because there is only one original check for any payment transaction, if the collecting bank and presenting bank had collected the original check instead of using a substitute check the bank would have been asked to make only one payment. The drawer could assert its warranty and indemnity claims against the paying bank, because that is the bank with which the drawer has a customer relationship and the drawer has received an indemnity from that bank. The drawer could recover from the indemnifying bank the amount of the erroneous charge, as well as the amount of the returned-check fees charged by both the paying bank and the payees of the returned checks. If the drawer's account were an interest-bearing account, the drawer also

could recover any interest lost on the erroneously debited amount and the erroneous returned-check fees. The drawer also could recover its expenditures for representation in connection with the claim. Finally, the drawer could recover any other losses that were proximately caused by the warranty breach.

b. In the example above, the paying bank that received the duplicate substitute checks also would have a warranty claim against the previous transferor(s) of those substitute checks and could seek an indemnity from that bank (or either of those banks). The indemnifying bank would be responsible for compensating the paying bank for all the losses proximately caused by the warranty breach, including representation expenses and other costs incurred by the paying bank in settling the drawer's claim.

2. * * * *

a. * * *

b. * * *

3. The amount of an indemnity would be reduced in proportion to the amount of any amount loss attributable to the indemnified person's negligence or bad faith. This comparative-negligence standard is intended to allocate liability in the same manner as the comparative-negligence provision of section 229.38(b).

* * * * *

36. In Commentary *XXXIII. Section 229.54 Expedited Recredit for Consumers* paragraph A is revised to read as follows:

XXXIII. Section 229.54 Expedited Recredit for Consumers

A. 229.54(a) Circumstances Giving Rise to a Claim

1. * * * * *

2. A consumer must in good faith assert that the bank improperly charged the consumer's account for the substitute check or that the consumer has a warranty claim for the substitute check (or both). The warranty in question could be a substitute-check warranty described in section 229.52 or any other warranty that a bank provides with respect to a check under other law. A consumer could, for example, have a warranty claim under section 229.34(a) or (e), which contain returned-check warranties that are made to the owner of the check.

* * * * *

By order of the Board of Governors of the Federal Reserve System, December 11, 2013.

Robert deV. Frierson (signed)
Robert deV. Frierson,
Secretary of the Board.