

FEDERAL RESERVE SYSTEM
12 CFR Part 229
[Regulation CC; Docket No. R-1034]

Availability of Funds and Collection of Checks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is requesting comment on options for amending Subpart C of Regulation CC, which contains rules governing the collection and return of checks. The proposed options would amend Subpart C's provisions on sending notices in lieu of returning the original checks. The proposal is intended to provide more flexibility to depository institutions to experiment with methods to return checks electronically.

DATES: Comments must be submitted on or before April 30, 1999.

ADDRESSES: Comments, which should refer to Docket No. R-1034, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551. Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Oliver I. Ireland, Associate General Counsel (202/452-3625), Stephanie Martin, Senior Counsel (202/452-3198), Legal Division. For the hearing impaired only, contact Diane Jenkins, Telecommunications Device for the Deaf (TDD) (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION:

Background

Subpart C of the Board's Regulation CC (12 CFR Part 229) contains rules governing the collection and return of checks. These rules are intended to expedite the check collection and return process, thereby reducing risk to banks¹ and their customers. Regulation CC was designed

¹ In Regulation CC and its Commentary, as well as in this docket, the term "bank" refers to all depository institutions, including commercial banks, savings institutions, and credit unions.

to work in accord with the state law check-collection rules in Articles 3 and 4 of the Uniform Commercial Code (U.C.C.), although in some areas the regulation preempts the U.C.C.

When a paying bank decides to return a check, the U.C.C. and Regulation CC require it to send the check or a notice within certain deadlines.² If a check is unavailable for return, U.C.C. 4-301(a) allows a paying bank to charge back the check by revoking provisional settlement based on a “notice of dishonor” (or a “notice of nonpayment” where the check is returned for reasons other than dishonor). The U.C.C. would appear to allow a paying bank to return a notice when a check has been truncated. The Official Comment to U.C.C. 4-301 states that an item may be considered unavailable for return if it is retained by the collecting bank in accordance with a bank check retention plan.

Regulation CC (§§ 229.30(f) and 229.31(f)) establishes a “notice in lieu of return,” which substitutes for the original check and carries value. The “notice-in-lieu” provisions of Regulation CC provide that the paying (or returning) bank must return the original check unless the check is unavailable, in which case the bank may return a copy of the front and back of the check, or, if no such copy is available, a written notice containing specified information about the check. The Commentary to §§ 229.30(f) and 229.31(f) states that 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. The Commentary explains that a check is not unavailable for return if it is merely difficult to retrieve from a filing system or from storage by a keeper of checks in a truncation system.

Regulation CC (§ 229.37) permits the parties to a check to vary the notice-in-lieu provisions; however, an agreement under Regulation CC cannot affect banks or customers that are not party to the agreement or otherwise bound by it. The Regulation CC variation-by-agreement provision differs from the corresponding language in U.C.C. 4-103 in that the U.C.C. allows Federal Reserve regulations and operating circulars, clearinghouse rules, and the like to be effective as agreements whether or not specifically assented to by all interested parties.³ Regulation CC does not incorporate the U.C.C.’s special treatment for Federal Reserve rules and operating circulars and clearinghouse rules but does not affect the status of such rules and circulars under the U.C.C.

² The paying bank must initiate the return by midnight of the banking day following the day the check was presented (U.C.C. 4-301). The paying bank must return the check so that it reaches the depository bank expeditiously, in accordance with § 229.30(a) of Regulation CC.

³ The Official Comment to U.C.C. 4-103 (note 3) indicates, however, that there are limitations on the scope of clearinghouse rules= ability to bind non-assenting parties.

Private-sector payments system participants have requested that the Board clarify the interrelationship of Regulation CC and the U.C.C. They have questioned whether Regulation CC limits a clearinghouse's ability to bind non-assenting third parties to a check truncation system under which the depository bank would receive a notice, such as in the form of an electronically-produced check image, in lieu of the return of the original check. These payments system participants stated that resolving uncertainty in this area could lead to greater experimentation and innovation in the provision of payments services.

The Board wishes to support development of new payments services and to take steps to remove any federal regulatory impediments to innovation in the payments area where appropriate. The Board is, therefore, requesting comment on options for amending Regulation CC and/or its Commentary to clarify the permissibility of notices in a check truncation environment instead of return of the actual check. The Board will consider the proposed regulatory changes in light of its statutory authority and responsibilities under section 609 of the Expedited Funds Availability Act (12 U.S.C. 4008(c)) to regulate any aspect of the payment system, including the check collection and return system, in order to carry out the provisions of the Act. The Board will consider the associated benefits and burdens of a regulatory change to the payment system as a whole as well as the implications for each party to a payment transaction affected by the rule. The Board also requests comment on whether there are other options that would be more appropriate than the two discussed below.

Options for notices in lieu of return

The Board is considering two options for amending the Regulation CC provisions on notices in lieu of return. The Board requests comment on the feasibility of these options, whether either of the options would remove impediments to the development of a more efficient payments mechanism, and the advantages and disadvantages of each option to the various participants in the check system, including depository banks, intermediary banks, paying banks, drawers, depositors, and non-depositor payees.

Option One. One of the purposes of subpart C of Regulation CC was to speed up the check return system that existed under the U.C.C. The U.C.C. contemplates that the paying bank will return a check to the presenting bank, which in turn will charge back the check against the prior collecting bank, and so on back up the forward collection chain until the check reaches the depository bank. Regulation CC eliminated the requirement that returned checks follow the forward collection chain. Under Regulation CC, the paying bank may send the returned check directly to the depository bank or to any returning bank, even if that bank did not handle the check for forward collection.

Regulation CC did not prohibit the return of checks back through the forward collection chain, but rather authorized banks to use a more efficient and direct route. Accordingly, one interpretation of Regulation CC is that banks may continue to return checks in accordance with the U.C.C. charge-back rules and the corresponding rules governing when notice may be sent

instead of the original check, subject to Regulation CC's expeditious return requirements. Under this interpretation, banks would need to follow the notice-in-lieu provisions of Regulation CC only if they wished to return the check through a route other than the forward collection chain. As noted above, the U.C.C. Official Comment indicates that the U.C.C. would allow return of a notice rather than the physical check in the event the check is being stored in accordance with a check retention system.

The Board could amend the Commentary to reflect this interpretation of the interplay of Regulation CC and the U.C.C. by stating that banks could send a notice of dishonor or nonpayment under the provisions of U.C.C. 4-301 when they return the notice through the forward collection chain, as contemplated in the U.C.C. The U.C.C. notices would be subject to the Regulation CC expeditious return rules. This proposal would clarify that banks can avail themselves of the U.C.C. rules regarding return of notices to the same extent they could before Regulation CC was adopted. This interpretation, however, may not provide relief for check truncation or image systems if returns do not follow the forward collection chain.

This option could also have consequences for the depositors or payees of the checks in that they would receive notices of returns rather than the original checks on a more frequent basis. They may have difficulty recovering from the drawers if they cannot obtain the original checks. Furthermore, despite the fact that the depositary bank could charge back its customer's account based on the notice in accordance with U.C.C. 4-214(a), the customer may, as owner of the check, ultimately have the right to possession of the check.

Option Two. Another approach would be for the Board to delete the Regulation CC Commentary language that explains when a check is unavailable for return. Specifically, the Board could remove the following provisions in the Commentary to §§ 229.30(f) and 229.31(f): 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. A check is not unavailable for return if it is merely difficult to retrieve from a filing system or from storage by a keeper of checks in a truncation system.

Instead of this language, the Commentary to those sections could indicate that notices in lieu of return are permissible whenever they would be permissible under the U.C.C.

The advantage of this option is that it would liberalize the circumstances under which banks could use notices in lieu of return and potentially make it easier for banks to establish electronic check return mechanisms that feature check truncation. The disadvantage of this option is that it would force depositary banks to accept notices from banks with whom they may have no established relationship. Under the U.C.C. charge-back system, banks receive returned checks or notices only from those banks to whom they sent the check for forward collection. Under Regulation CC, a return could come directly from the paying bank or from an unfamiliar returning bank. Banks in the past have expressed concern about the quality of some notices of nonpayment. Some have stated that they are reluctant to charge back their customers' accounts

on the basis of notices of nonpayment but prefer to wait for the return of the original check. Under this option, the return of a notice in lieu of an original check could become more prevalent, and the depository bank would have to charge back based on that notice, as the original check might never be returned. Notices in the form of an electronically-produced check image, however, may be more reliable than other types of notices that describe the check, depending on the quality of the image. This option could also have consequences for the depositors or payees of the checks as discussed above under option one.

Amendment regarding electronic check presentment agreements

The Board is also proposing to delete ' 229.36(c) of Regulation CC and its associated Commentary, which states that a bank may present a check electronically under an agreement with the paying bank and that the agreement may not extend return times or otherwise vary the provisions of Regulation CC with respect to persons not party to the agreement. This provision of the regulation is subsumed by the variation-by-agreement provisions in ' 229.37, and the Board believes it is unnecessary and potentially confusing to retain special provisions regarding a particular type of variation by agreement. The Board proposes to add an example to the Commentary to § 229.37 listing an electronic check presentment agreement as a permissible variation by agreement under Regulation CC. Eliminating ' 229.36(c) and its Commentary would result in no substantive change to the regulation regarding the validity of electronic presentment agreements.

Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (5 U.S.C. 603) requires an agency to publish an initial regulatory flexibility analysis with any notice of proposed rulemaking. Two of the requirements of an initial regulatory flexibility analysis, a description of the reasons why action by the agency is being considered and a statement of the objectives of, and legal basis for, the proposed rule, are contained in the supplementary material above. The proposed rules require no additional reporting, recordkeeping, or other compliance requirements and do not overlap with other federal rules. The proposed rule would apply to all depository institutions and other entities who participate in the check collection system, regardless of size. The Board believes that the proposed rule could result in depository banks (of all sizes) being required to accept more notices in lieu of returned original checks and has requested comment on the burdens associated with that aspect of the proposal. The Board believes, however, that it would not be feasible to create different check return rules for large and small banks, and therefore no alternatives for small banks were considered.

List of Subjects in 12 CFR Part 229

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

For the reasons set forth in the preamble, 12 CFR Part 229 is proposed to be amended as set forth below:

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

1. The authority citation for part 229 continues to read as follows:

Authority: 12 U.S.C. 4001 et seq.

2. In § 229.36, paragraph (c) is removed and reserved.

OPTION ONE

3a. In Appendix E, under section XVI, paragraph F.2. is revised to read as follows:
Appendix E to Part 229-- B Commentary

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XVI. Section 229.30 Paying Bank’s Responsibility for Return of Checks

* * * * *

F. * * *

2. Sending a notice in lieu of return in accordance with this section satisfies the requirements of U.C.C. 4-301(a) to send a notice of dishonor or nonpayment. A paying bank could also send a notice in accordance with U.C.C. 4-301(a) (which requires returned checks and return notices to flow back through the forward collection chain) if it did not wish to avail itself of the provisions of this section, provided that the notice met the expeditious return requirements of this section. Reference in the regulation and this commentary to a returned check includes a notice in lieu of return under this section or a notice of dishonor or nonpayment under U.C.C. 4-301(a) unless the context indicates otherwise.

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END OF OPTION ONE

OPTION TWO

3b. In Appendix E to part 229, under section XVI, paragraph F. 1. is amended by removing the fifth and sixth sentences and by adding a new sentence after the fourth sentence to read as follows:

XVI. Section 229.30 Paying Bank's Responsibility for Return of Checks

* * * * *

F. * * *

1. * * * This paragraph adopts the standards of U.C.C. 4-301(a) as to when a check is unavailable for return. * * *

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3c. In Appendix E, under section XVII, the second and third sentences of paragraph F.1. are removed.

END OF OPTION TWO

4. In Appendix E, under section XXII, paragraph C. is removed and reserved.

5. In Appendix E, under section XXIII, a new paragraph C.9. is added to read as follows:

XXIII. Section 229.37 Variations by Agreement

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C. * * *

9. A presenting bank and a paying bank may agree that presentment takes place when the paying bank receives an electronic transmission of information describing the check rather than upon delivery of the physical check. (See § 229.36(b).)

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By order of the Board of Governors of the Federal Reserve System, February 19, 1999.

/signed/
Jennifer J. Johnson,
Secretary of the Board.