

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: Final rule.

SUMMARY: The Board is adopting amendments to Subpart C of Regulation CC, which contains rules governing the collection and return of checks. The amendments to the regulation and Commentary are intended to provide further clarification as to the extent to which depository institutions and others may vary the terms of the regulation by agreement for the purpose of instituting electronic return systems.

EFFECTIVE DATE: December 15, 1999.

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SUPPLEMENTARY INFORMATION:

Background

In February 1999, the Board requested comment on options for amending provisions in Regulation CC governing when paying or returning banks may send notices instead of returning the original checks.^{1/} The purpose of the proposal was to explore whether more flexibility is needed to enable check system participants to experiment with methods to return checks electronically.

^{1/} 64 FR 9105, Feb. 24, 1999.

The collection and return of checks is governed by both Regulation CC and state law (Articles 3 and 4 of the Uniform Commercial Code (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.^{1/} The U.C.C. and Regulation CC differ on when a bank can return a notice rather than the check itself. If a check is unavailable for return,^{2/} U.C.C. 4-301(a) allows a paying bank to charge back the check by revoking its provisional settlement with the presenting bank based on a notice of dishonor or nonpayment. The Official Comment to U.C.C. 4-301 states that a check may be considered unavailable for return if, under a collecting bank check retention plan, presentment is made by a presentment notice and the check is retained by the collecting bank. Presumably, therefore, the U.C.C. would allow a paying bank to return a notice when a check has been truncated. (It is not clear whether a check would be deemed unavailable for return under the U.C.C. if the paying bank, rather than the collecting bank, retains it.)

Regulation CC (' ' 229.30(f) and 229.31(f)) establishes a notice in lieu of return,^{3/} 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 notice that meets certain information requirements. The Regulation CC Commentary states that notice is permitted in lieu of return 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.

The primary reason for the difference between the U.C.C.'s and Regulation CC's treatment of notices is that there is likely to be less risk for a depository bank in accepting a notice (instead of the original check) from a bank it knows than from a bank it doesn't know. Under the U.C.C., the paying bank returns a check to the presenting bank, which in turn charges back the check against the prior collecting bank, and so on back up the forward collection chain until the check reaches the depository bank. Therefore, under the U.C.C., the depository bank receives returns from the bank to which it had sent the check for collection and with which it has a previously established relationship. One of the purposes of Regulation CC was to speed up the check return system that existed under the U.C.C. Regulation CC eliminated the requirement that returned checks follow the forward collection chain. Under Regulation CC, the paying bank may

^{1/} 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.

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. Therefore, under Regulation CC, depository banks may receive returned checks from banks with which they have no previous relationship.

Some check system participants asked the Board to clarify the interrelationship between the U.C.C. and Regulation CC in order to provide additional legal certainty for institutions that wish to experiment with electronic return systems, under which they would return images or other notices rather than the checks. These participants were concerned about their ability to bind all relevant parties to an electronic return arrangement under the variation-by-agreement provisions of Regulation CC. 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, customers, or others 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 clearinghouse rules (as well as Federal Reserve regulations and operating circulars) 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 clearinghouse rules (or for Federal Reserve rules and circulars) but does not affect the status of such under the U.C.C.

This difference in variation-by-agreement provisions exists because Regulation CC does not govern the relationship between banks, their customers, and remote parties to the extent that the U.C.C. does. While Board rules can bind depository institutions, the Board does not appear to have the authority under the Expedited Funds Availability Act to bind depositors or payees to an electronic check return system. Section 611(f) of the Act, which authorizes the Board to establish rules allocating loss and liability in the payments system, applies to loss and liability among depository institutions only. The Act does not authorize such allocations to customers of depository institutions.

Although banks would be able to obtain agreement to the terms of an electronic return arrangement from their customers through account agreements, under Regulation CC they would not be able to bind remote parties to the check, such as non-depositor payees. Some check system participants sought an amendment to Regulation CC that would eliminate the risk that

^{3/} The Official Comment to U.C.C. 4-103 (note 3) indicates, however, that there are limitations on the scope of clearinghouse rules. The Comment notes that clearinghouses are not authorized to rewrite the basic law generally and that clearinghouse rules should be understood in the light of functions the clearinghouses have exercised in the past.

these remote third parties would bring a claim under Regulation CC in the event they suffered losses due to the fact that a check was returned electronically rather than in physical form. A claim could potentially arise under the following circumstances:

Drawer A writes and delivers a check payable to Payee B. Payee B negotiates the check to Depositor C, who deposits the check in his bank. Depositor C's bank presents the check to Drawer A's bank. Both banks are participating in an electronic return system, and Drawer A's bank returns an image of the check to Depositor C's bank, which, in turn, charges Depositor C's account. Depositor C would have to attempt to collect the funds from Payee B or Drawer A without the physical check. Assuming that Depositor C has agreed to the electronic return system through an account agreement, Depositor C would bear the risk that Payee B or Drawer A would not pay without the original check. (Payee B or Drawer A may be concerned about the risk of double payment if the original check is not returned.) If Payee B pays Depositor C in return for the check image or similar notice, Payee B may still be unable to collect from Drawer A without the check and could suffer losses (although Payee B may still have recourse against Drawer A under the U.C.C. even without the original check). Presumably, an electronic return arrangement would allow banks or customers to request the original check within a certain amount of time. If Drawer A becomes insolvent before the original check is retrieved, Payee B would suffer losses. If Payee B would have been able to collect from Drawer A had Payee B originally received the check rather than the notice, then Payee B's losses would likely be attributable to the electronic return system.

Regulation CC imposes a duty on banks to exercise ordinary care and act in good faith in handling checks under Regulation CC. This duty runs to the depository bank, the depository bank's customer, the owner of a check, or another party to the check. If a bank violates these duties, resulting in harm to one of these parties, the party may have a claim against the bank for damages. Therefore, if a bank returned a notice-in-lieu when the physical check was deemed **Available** under Regulation CC, and the return of the notice rather than the physical check caused a party to the check to incur a loss, the bank potentially could be liable for damages. The bank sending the notice could be liable even if it had agreed with the receiving bank to use notices in lieu of return. The injured party would have to show lack of good faith or failure to exercise ordinary care.

The risk of a bank becoming liable to a remote third party under the circumstances described above appears to be low. Nevertheless, some check system participants stated that they were reluctant to begin experimenting with electronic check return systems without additional protection. To flesh out the pros and cons of making regulatory changes in this area, in February 1999 the Board sought commenters' input on two options.^{4/}

The first option was to amend the Commentary to Regulation CC to state that banks could send a notice of dishonor or nonpayment in accordance with 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

^{4/} 64 FR 9105, Feb. 24, 1999.

U.C.C. notices would be subject to the Regulation CC expeditious return rules. This proposal would clarify that banks could avail themselves of the U.C.C. rules regarding return of notices to the same extent that they could before Regulation CC was adopted. The Board noted, however, that this proposal may not provide relief for check truncation or image systems if returns do not follow the forward collection chain and that it could have consequences for the depositors or payees of the checks, who may have difficulty recovering from the drawers without the original checks.

The second option was to delete the Regulation CC Commentary language that explains when a check is unavailable for return. Instead of this language, the Commentary would indicate that notices in lieu of return are permissible whenever they would be permissible under the U.C.C. The Board noted that this option 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, but would force depository banks to accept notices from banks with whom they may have no established relationships. This option could also have consequences for the depositors or payees of the checks as discussed above under option one.

The Board also proposed 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 it may be unnecessary and potentially confusing to retain special provisions regarding a particular type of variation by agreement. The Board proposed 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. The Board noted that eliminating ' 229.36(c) and its Commentary would result in no substantive change to the regulation regarding the validity of electronic presentment agreements.

Summary of Comments

The Board received 72 comments on its proposed options, classified as follows:

Banks/Bank holding cos:	32
Thrifts/Thrift holding cos:	2
Credit unions/Corporate credit unions:	9
Trade associations representing:	
Banks	5
Credit unions	5
Clearing houses	2
Non-banks	2
Clearing houses/organizations:	9
Federal Reserve Banks:	2
Non-bank service providers:	4

Problems raised by notices in lieu of returns. Overall, the commenters were supportive of changes that would improve efficiency and reduce risk in the check collection and return system, but were reluctant to support changes that would impose costs on depository banks, their customers, and other parties to the check without their consent. Thirty-five commenters specifically discussed the problems that would arise if depositors received notices of returned checks instead of the physical checks. Many of these commenters echoed the problems stated by the Board in its proposal, i.e. that customers generally expect checks to be returned to them when their accounts are charged back and that customers have ownership rights in the physical checks. Commenters were concerned about whether their customers would be able to collect from drawers without the original checks and some noted that the drawer's risk of double payment needs to be addressed. Some of these commenters stated that the U.C.C. limits a holder's rights to enforce a check without possession of the physical item. Several commenters raised concerns about whether a notice of a returned check would be sufficient evidence of the return in court, and others noted that law enforcement authorities often require the original check in order to lift fingerprints from the check or examine the handwriting. Four commenters, however, stated that even though the customer, as the legal owner, may have a right to the original check, there may be no practical consequence if an image or other electronic return has legal equivalence under the U.C.C. or the Uniform Electronic Transactions Act.^{1/}

Twenty-one commenters raised concerns about whether the information provided on a notice-in-lieu-of-return would be sufficient to allow the depository bank to charge back its customer's account. The commenters listed such necessary information as the indorsement (especially on third-party checks), the check date, the payee, the amount, the reason for return, the teller stamp, trace numbers, and the account number. Some commenters noted that missing information is already a problem for notices-in-lieu under the current regulation. Some of these comments were related to concerns about the quality of the photocopy or image that depository banks would receive, and others were related to the sufficiency of information in an electronic notice that did not include an image of the check. One commenter suggested that if notices-in-lieu become more permissible, then all of the information requirements of ' 229.33(b) should be mandatory and no questions marks allowed.

Costs and benefits of electronic returns. Thirty-one commenters specifically mentioned the benefits of an electronic return system. These commenters generally believe that electronic returns will enable checks to be returned faster and will allow depository banks and their customers to protect themselves better against check fraud. They stated that an electronic return system would lead to operational savings and make forward check truncation feasible.

^{1/} The Uniform Electronic Transactions Act is a model law drafted and approved by the National Conference of Commissioners on Uniform State Laws and recently adopted in California. It does not provide that a check image or other electronic returned check is legally equivalent to the original check, except for limited record-keeping purposes.

On the other hand, eight commenters believed that the costs of an electronic return system could likely outweigh the benefits. The commenters noted that costs could take the form of incomplete information to the depository bank, potentially resulting in delays in charging back the customer's account, as well as the expense of hardware and software to operate an electronic return system.

Six commenters discussed the potential competitive effects of establishing an electronic return system. These commenters were generally concerned that community banks and other small depository institutions may not be technologically prepared for electronic returns and should not be placed at a disadvantage by any regulatory change.

Option One. Only one commenter expressed a preference for option one. Thirty-two commenters pointed out specific problems that would arise if the Board were to adopt option one. Many stated that application of option one would be too limited in scope to provide sufficient incentive for experimentation in electronic returns. Several commenters believed that certain checks may be impossible to return through the forward collection chain within the expeditious return deadlines. Others commented that the U.C.C. standards are not clear as to what information must be included in a U.C.C. notice of nonpayment and were concerned that the depository bank would not receive information sufficient to charge the check back to its customer's account. Some commenters believed that adoption of option one would lead to confusion as to when the U.C.C. applied to a returned check rather than Regulation CC, and one commenter noted that state-to-state variation in the meaning of **Unavailable for return** could lead to confusion with respect to interstate transactions. Commenters raised other questions as to the implementation of option one, such as (1) whether the presenting bank that receives a U.C.C. notice of nonpayment, but holds the truncated physical check, has the option to either send a notice or the check to depository bank and (2) whether the physical check must be made available to the depository bank or its customer upon request.

Option Two. Eighteen commenters supported proposed option two, although nearly all of those commenters raised additional issues that they believed should be addressed. The Electronic Check Clearing House Organization (ECCHO) and seventeen other commenters supported option two so long as the regulation made clear that the depository bank would have to agree to receive electronic notices in lieu of return. These commenters stated that experimentation with electronic notices should be conducted on a voluntary basis, governed by bilateral or multilateral agreements. The commenters stated that the depository bank would need to know from whom it would be receiving electronic returns and would have to work out such issues as who would own the returns/images, acceptable quality standards, who to contact in case of problems, and what procedures to follow. One supporter of option two, however, did not expect that the receipt of unexpected electronic returns from unfamiliar banks would be widespread. This commenter stated that the issue of the quality of electronic returns from unfamiliar banks would be an operational matter that would likely be self-regulated between paying banks and depository banks and should be left for the banks to police.

Eleven commenters discussed specific problems regarding option two. Some of these commenters raised issues related to dealing with an unknown returning bank. They stated that

accepting notices from banks with which the depository bank has no relationship could pose significant financial or customer service risk exposure. They also said that handling returned items could become more complex and time-consuming if images are received from multiple sources, and the amount of manual sorting could outweigh the advantages of new technology. Another concern raised by the commenters was that option two could increase the use of notices in lieu of returns, placing the burden on the depository bank in providing the depositor with the information on the return item when a charge-back occurs without the physical check. The commenters also raised other matters that would need to be addressed under option two, such as (1) whether the presenting bank that receives a notice but holds the physical check has the option to send either the notice or the check to the depository bank and (2) whether the physical check must be made available to the depository bank or its customer on request.

Other comments on options. Seventeen commenters opposed both options. Most of these commenters stated that the proposals would make the return process more complicated, particularly in connection with reconciliation, without a comprehensive all-electronic approach. They stated that the Board should address other issues related to electronic returns before adopting either option. One commenter favored either option, stating that either would accomplish the goal of reconciling Regulation CC with the U.C.C. as to when a check is available for return.

Most of the commenters suggested additions or enhancements to the two options proposed by the Board:

Variation by agreement. Nine commenters stated that the Board should permit clearing house rules to vary Regulation CC in same way as they vary the U.C.C. The commenters stated that this would avoid the need to change Regulation CC to accommodate innovations and would put private-sector banks on a more equal footing with non-banks and Federal Reserve Banks.

The Federal Reserve Bank of Atlanta (FRB Atlanta) believed that the concern as to whether ' 229.37 of Regulation CC limits the ability of an agreement to bind remote parties is ameliorated by at least two factors: (1) FRB Atlanta stated that the only remote party right under Regulation CC is the right to receive a notice of return, which can be met by an image of sufficient quality to permit the depository bank to identify its customer; other remote party rights arise under the U.C.C. and can be addressed in the context of agreements under the U.C.C.; and (2) At least one court decision^{6/} held that the depository bank, as the collection agent for its customer, can enter into agreements on behalf of the customer without prior consent as long as agreement is reasonable. FRB Atlanta stated that accepting an image return (with the paper check to follow) seems to be reasonable. FRB Atlanta suggested, as an alternative to the proposed options, that the Board revise the Commentary to ' 229.37 to provide that depository bank may agree with paying

^{6/} Graubert v. Bank Leumi, 399 N.E. 2d 930 (Ct. App. N.Y. 1979).

or returning banks to accept images or other notices of dishonored checks as notices in lieu of return and that those banks may be responsible under other applicable law to parties interested in the check for any losses caused by the handling of check returns under such agreements (except to the extent addressed in effective agreements with those other parties).

U.C.C. availability requirement. Three commenters stated that the proposal's reference to U.C.C. 4-301 is not sufficient because it is not clear what types of check programs are encompassed by the U.C.C.'s Official Comment to 4-301 regarding Availability of checks for return. The commenters suggested that the Regulation CC Commentary should specifically permit notice in lieu of return when a check is difficult to retrieve from a filing system or from storage pursuant to a truncation, image or other check electronication program, provided the receiving bank has agreed to accept notices in lieu of return in such circumstances.

Two commenters raised other questions concerning what sorts of truncation arrangements are contemplated by U.C.C. 4-301(a). These comments reflected the uncertainty as to whether it matters which bank in the collection or return chain is the truncating bank in determining if a check is unavailable for return under the U.C.C.

Three commenters suggested that the Board allow a bank to provide a notice-in-lieu at will, rather than only when the original check is unavailable for return. These commenters noted that such returns may not be permissible under the U.C.C., but they anticipated that the U.C.C. or its state variations may become less restrictive in the future as technology changes.

Address legal status of images. Five commenters requested that the Board address the legal status of images to provide comfort that an image or electronic notice legally replaces the original check. Some of these commenters suggested that the Commentary should explicitly state that images are acceptable in the U.S. check collection and return system to bolster banks' ability to convince customers to accept images in lieu of the original check.

Establish standards. Fifteen commenters asked the Board to establish standards for an electronic return system. The commenters expressed a need for standards in areas such as image quality, standardized return reason codes, data communication, procedures to verify system integrity and compatibility, and indorsements. Some of these commenters stated that the Board should set time limits for the returning bank to provide the depository bank with the paper check and procedures for request and retrieval. One commenter stated that the Board should provide for migration to more image-friendly check stock. Another commenter stated that a new regulatory infrastructure is necessary to address detailed issues, even more specifically than the Board's same-day settlement provisions in Regulation CC.

Address return deadlines. Seven commenters stated that the Board should clarify how an electronic return system would affect return deadlines. For example, one commenter suggested that the Board should clarify when the return clock starts if checks are presented electronically and the physical item is necessary to create a return. Other commenters suggested that the Board amend Regulation CC to provide that, if a bank sends image returns under a truncation

arrangement where the check was presented electronically, it would not be required to meet the U.C.C. return deadline. The commenters stated that this rule would nurture the development of electronic check presentment and would enable the paying bank to examine the physical check and create an image return without violating the U.C.C. midnight deadline.

Representation. Eleven commenters stated that the Board should address how a depository bank could represent a check that had been returned electronically. They said that representation of checks returned electronically would pose technical and operational challenges, including the form of the represented check and what would replace the indorsement audit trail. One commenter suggested that the Board establish redeposit rules allowing for prompt representation of electronic returns to protect consumers from the potential loss from dishonored checks.

Depository bank protections. Thirteen commenters requested that the Board take steps to protect depository banks under electronic return systems. Several commenters suggested that the depository bank should be able to send back an electronic return and require return of the physical check instead. Other commenters suggested providing warranty protection for the depository bank by requiring the bank that sends an electronic return to indemnify a depository bank that charges back its customer based on the electronic return. One commenter also stated that the depository bank and its customers should receive guarantees that the original check will not be returned.

Allow images only. Ten commenters suggested that the Board limit electronic return to images only. One of these commenters stated that the regulation should reflect a preference in favor of check imaging rather than the transmission of a detailed accounting of the check. Another commenter stated that the regulation should discourage the proliferation of written notices, which are often incomplete and expose the depository bank to undue risk.

Address coordination issues. Two commenters suggested that the Board should address various issues related to the interaction of an electronic return system with other electronic payment initiatives. One commenter asked for clarification as to how a paying bank could return an image if it is receiving check presentment electronically. This commenter also asked how a depository bank could create ACH returned-check entries (RCKs) without the physical checks. Another commenter suggested that the Board should provide a statement authorizing use of a notice in lieu of return when the check has been processed electronically and returned to its owner at the point of sale. The commenter stated that this would encourage increased experimentation with electronic check truncation at the point of sale.

Comprehensive approach. Seven commenters believed that the Board should take the lead in working with the industry on a comprehensive approach to structuring an all-electronic return process. One commenter stated that electronic returns need to be part of a new regulatory approach for overall check electrification. Another commenter stated that the Board should express its willingness to consider and act on appropriate regulatory changes on an ongoing basis during the transition to electronics in check processing. Another commenter suggested that the Board fund a nationwide education and marketing campaign to ensure consumer and corporate

acceptance of images in lieu of checks. Finally, one commenter stated that the current return rules hold the check system hostage to the needs of a few payees, and the Board should endorse the notice-in-lieu process more enthusiastically rather than merely condoning it.

Implementation date. Seven commenters made statements regarding the implementation date of any rule change. Most of these commenters favored implementation as quickly as possible, but one commenter asked for at least one year lead time to allow for updating of internal systems.

Amendments to ' ' 229.36 and 229.37. Seven commenters explicitly supported the proposed amendments to ' ' 229.36 and 229.37 regarding electronic presentment agreements. One commenter suggested that the restriction on the expansion of check return deadlines should be retained explicitly.

Board staff invited all of the public commenters to participate in a meeting on July 26 to discuss issues related to the proposed amendments. Twenty-eight commenters attended the meeting.

Discussion

As indicated in the comment summary, overall, most commenters were open to the idea of an electronic return system but were very concerned about the effects of such a system on depository banks and their customers. Many commenters were reluctant to support regulatory changes without knowing the details of how an electronic return system would work and how they and their customers would be protected. This concern prompted many commenters to suggest that the Board, in cooperation with banks, establish more detailed rules and standards that would govern such a system. The Board continues to believe that practices and standards would be developed most efficiently through commercial practice and market experimentation rather than by regulation. The Board believes that its appropriate role is to facilitate experimentation by determining whether its rules create barriers to experimentation and if so, whether those rules can be changed without creating undue adverse affects.

As noted above, under Regulation CC, the inability to bind remote parties to an interbank agreement could lead to liability on the part of banks for relying on electronic returns. Some participants in the July 26 meeting reiterated that it is this potential liability they would like to avoid. ECCHO and various others suggested in their comment letters that the Board adopt option two but permit an electronic return only if the depository bank agrees to accept it. ECCHO restated its proposal at the July 26 meeting, laying out a 3-part plan for revising option two: (1) All of the banks involved, including the depository bank, would have to agree to participate in any electronic check return program, (2) a notice in lieu of return, whether specifically permitted under Regulation CC or permitted as part of an interbank agreement on electronic check returns, would satisfy the requirements of Regulation CC to the same extent as the return of the original paper check for all bank and non-bank parties to the check, and (3) banks that are parties to an electronic return agreement may be liable under other law to non-bank parties unless that liability is covered by other agreements.

Most of the discussion at the July 26 meeting focused on the cut-off of rights under ECCHO's point (2), which would shield participating banks against claims by remote parties under Regulation CC but would not operate as a shield against claims under other law. (Presumably, ECCHO and others would rely on their ability to bind remote parties by clearinghouse rules under the U.C.C. to address these potential claims.) The Board's proposed option two would have cut off Regulation CC rights, but those rights would have been cut off for both banks and non-banks. The ECCHO proposal would allow banks to opt out of the electronic return arrangement but would not allow their customers or other parties to the check to do so. Supporters of the ECCHO proposal reasoned that this distinction was justified because depository banks would have to make operational changes to be able to accept electronic returns, but depositors and others would not necessarily need to make such changes.

Meeting participants were unable to quantify the risk presented by the possibility that non-assenting parties may assert Regulation CC rights if an electronic return program caused them to incur losses. In general, participants agreed that, because banks can generally obtain assent from their customers through deposit agreements, the most serious risks would be from potential claims by remote third parties, such as non-depositor payees, unless those rights are cut off. ECCHO and some of the bank representatives stated that the uncertainty as to the size of this risk was preventing banks from investing in pilot electronic return programs. Without quantifying this risk, some banks stated that they are unable to judge whether the benefits of an electronic return system outweigh the risks, although some bank representatives said that they had not made a focused attempt to determine the magnitude of the risk. At the close of the meeting representatives from ECCHO and certain banks stated that they would take a closer look at the risks of claims from non-assenting parties under Regulation CC to determine whether those risks are actually outweighed by the perceived benefits to banks of electronic returns.

In a subsequent letter to the Board, ECCHO reiterated its support for a Regulation CC amendment that would incorporate its proposal as outlined at the meeting.¹⁷ In its letter, ECCHO argued that its proposal would result in increased efficiency in the check return system that would

¹⁷ The Board received five other follow-up letters from organizations that attended the July 26 meeting. The letters supported the ECCHO proposal in general, but some stated that the Board should seek additional comment before adopting the ECCHO proposal.

benefit banks as well as depositors in terms of protection against check fraud. ECCHO believes that customer service incentives will lead banks to make the original paper checks available to customers within a reasonable window of time and that banks that are not comfortable with the arrangement can opt out.

ECCHO's proposal would eliminate the risks of potential Regulation CC claims against banks that participate in electronic check return systems. The risk would, in effect, be shifted from depository banks to their customers and remote third parties. Those who favor this proposal have not demonstrated the magnitude of this risk. They state that the risk is significant enough to prevent banks from experimenting with electronic returns. On the other hand, they state that shifting the risk to non-bank parties is justified by the efficiencies and cost-savings that an electronic return system would bring. The Board's proposed option 2 would also, in effect, shift this risk to non-bank parties to the check, as well as to depository banks. The Board believes that the risk of Regulation CC claims by remote third parties is quite low and finds it difficult to justify shifting that risk to the remote third parties to benefit banks that have agreed among themselves to return checks electronically. The barrier that the current regulation presents to electronic check return does not appear to be significant enough to warrant shifting risks to non-assenting parties. Further, the commenters indicated that proposed option one would not be useful in many situations where checks are not returned back through the forward collection chain.

Instead, the Board has taken a different approach, similar to that suggested by FRB Atlanta. The Board has revised the Commentary to ' 229.37 to clarify that depository banks may agree with paying or returning banks to accept images or other notices in lieu of returned checks even when the checks are available for return under Regulation CC. Except to the extent that other parties interested in the checks assent to or are bound by the banks' agreements, banks entering into such agreements may be liable under Regulation CC or other applicable law to other interested parties for any losses caused by the handling of returned checks under such agreements. This revision leaves the rights of depository banks, depositors, and remote parties intact under both Regulation CC and the U.C.C., avoiding the potential consumer issues of the proposed options and the ECCHO proposal.

Given the Board's action, the final analysis of any electronic return system will be driven by a cost decision on the part of the banks involved. If the cost savings of an electronic return system will be as great as some check system participants expect, then the risk of Regulation CC claims by non-assenting remote third parties may be outweighed by those savings and could be absorbed by participating banks. The Board notes that banks have taken on these risks in other

contexts. For example, the banks that are participating in the Federal Reserve electronic return pilot in Montana have agreed to assume the risk of claims by non-assenting parties.^{1/}

The Board believes that the best long-term solution to this particular electronic return issue, as well as other issues related to the electronic collection and return of checks, would best be addressed in a coordinated effort to bring subpart C of Regulation CC and the U.C.C. into conformance. The Board is pursuing this solution with the National Conference of Commissioners on Uniform State Laws.

In addition, as proposed, the Board has removed the electronic presentment agreement provisions from ' 229.36(c) and its related Commentary and added a corresponding example to the Commentary to ' 229.37. These amendments will not have any substantive effect.

^{1/} In other electronic payment experimental programs, banks have been willing to assume risks that appear to be more significant than the risk presented in this instance. For example, under recently adopted National Automated Clearing House Association rules that allow check payees to collect the funds from the checks through the automated clearing house (ACH) under certain circumstances, the bank that originates the ACH transaction warrants that all signatures on the check are genuine and that the underlying paper check will not be presented, even though the bank itself may not have possession of or control over the check.

Regulatory Flexibility Act Certification

In accordance with section 605 of the Regulatory Flexibility Act, (12 U.S.C. 605), the Board certifies that the amendments to Regulation CC and its Commentary will not have a significant economic impact on a substantial number of small entities. The amendments will clarify the extent to which banks may agree to vary the terms of Regulation CC by agreement to experiment with electronic return systems, but will not affect any entities who have not agreed.

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 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.

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

4. In Appendix E, under section XXIII, new paragraphs C.9. and C.10. are added to read as follows:

XXIII. Section 229.37 Variations by Agreement

* * * * *

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).)

10. A depository bank may agree with a paying or returning bank to accept an image or other notice in lieu of a returned check even when the check is available for return under this part. Except to the extent that other parties interested in the check assent to or are bound by the variation of the notice-in-lieu provisions of this part, banks entering into such an agreement may be responsible under this part or other applicable law to other interested parties for any losses caused by the handling of a returned check under the agreement. (See ' ' 229.30(f), 229.31(f), 229.38(a).)

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By order of the Board of Governors of the Federal Reserve System, October 27, 1999.

(Signed) Robert deV. Frierson

Robert deV. Frierson,
Associate Secretary of the Board.