

# BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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**Date:** May 7, 2021

**To:** Board of Governors

**From:** Staff<sup>1</sup>

**Subject:** Proposed Amendments to Regulation J (Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire) to Govern Transfers over the FedNow<sup>SM</sup> Service

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## Action Requested

Approval to publish the attached notice of proposed rulemaking (NPR), which would amend Regulation J and its official commentary to: (i) establish a new subpart C to govern funds transfers over the Federal Reserve Banks' (Reserve Banks') new FedNow Service, (ii) clarify existing subpart B (governing the Fedwire Funds Service) to reflect the fact that the Reserve Banks will be operating a second funds transfer service in addition to the Fedwire Funds Service, and (iii) make technical corrections to subpart A (governing the Reserve Banks' check service).<sup>2</sup>

## Summary

Regulation J (12 CFR part 210) provides the legal framework for the collection and return of checks through the Federal Reserve System (subpart A) and specifies terms and conditions governing funds transfers over the Fedwire Funds Service (subpart B). Subpart B of Regulation J sets out the rights and responsibilities of parties to a funds transfer over the Fedwire Funds Service, providing legal clarity and certainty on important aspects of the service. However, the provisions of Regulation J currently would not apply to transfers over the new FedNow Service, which will be a separate funds transfer service operated by the Reserve Banks. In order to avoid a potential lack of legal clarity regarding funds transfers over the FedNow Service, staff recommends the addition of a new subpart C to provide a clear, predictable, and comprehensive set of foundational rules for the service.

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<sup>1</sup> Ms. Martin, Ms. Cheng, and Mr. Smith (Legal Division); Ms. Foley, Mr. Spear, and Ms. Wells (Division of Reserve Bank Operations and Payment Systems).

<sup>2</sup> Staff requests the authority to make technical, non-substantive changes to the NPR prior to public, if needed.

## **Background on the FedNow Service and Regulation J**

In 2019, the Board announced that the Reserve Banks would develop a new interbank 24x7x365 real-time gross settlement service with integrated clearing functionality, called the FedNow Service, to support instant payments in the United States (the 2019 Notice).<sup>3</sup> In the 2019 Notice, the Board requested comment on all aspects of the planned service. One proposed aspect was a requirement that banks using the service make funds associated with individual instant payments available to their end-user customers immediately after receiving notification of settlement from the service.

In 2020, the Board announced further details about the FedNow Service (the 2020 Notice).<sup>4</sup> In the 2020 Notice, the Board approved, among other things, the aspect of immediate funds availability proposed in the 2019 Notice. The Board also indicated that it was assessing applicable laws and regulations and would request public comment to the extent changes to the Board's regulations were needed.

Staff has completed this assessment with respect to Regulation J and propose a new subpart C of Regulation J to provide a comprehensive set of rules governing funds transfers over the FedNow Service. To support instant payments, proposed subpart C also includes a requirement for a FedNow participant that is the beneficiary's bank to make funds available to the beneficiary immediately after it has accepted the payment order over the service. The NPR also proposes to adopt a commentary to subpart C that constitutes a Board interpretation of the regulation.

## **Proposed New Subpart C of Regulation J to Govern the FedNow Service**

The NPR's proposed amendments to Regulation J would establish a new subpart C to specify the terms and conditions under which Reserve Banks will process funds transfers over the FedNow Service. Many of the concepts embodied in the proposed subpart C are similar to those in subpart B, which governs funds transfers over the Fedwire Funds Service. Like the Fedwire Funds Service, the FedNow Service is a real-time gross settlement system and a funds-

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<sup>3</sup> "Federal Reserve Actions To Support Interbank Settlement of Faster Payments, Request for Comments," 84 FR 39297 (Aug. 9, 2019).

<sup>4</sup> "Service Details on Federal Reserve Actions To Support Interbank Settlement of Instant Payments," 85 FR 48522 (Aug. 11, 2020).

transfer service under the Uniform Commercial Code (UCC) Article 4A.

The Board incorporated UCC Article 4A, as approved by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1989, into subpart B of Regulation J to govern the Fedwire Funds Service.<sup>5</sup> The NPR proposes to do the same for the FedNow Service in the proposed new subpart C.

The new subpart C would apply UCC Article 4A to all transfers over the FedNow Service. Because the FedNow Service also is designed to accommodate consumer use, consumer transfers over the service might meet the definition of “electronic fund transfer” under the Electronic Fund Transfer Act (EFTA).<sup>6</sup> By its terms, UCC Article 4A would not apply to a funds transfer any part of which is governed by the EFTA as an “electronic fund transfer.”<sup>7</sup> Therefore, absent proposed subpart C, a number of important aspects of consumer transfers over the FedNow Service could lack clear and consistent rules.

Specifically, proposed subpart C incorporates UCC Article 4A into Regulation J and provides that its provisions apply to all transfers over the FedNow Service, even those that might meet the definition of an “electronic fund transfer” under the EFTA; however, in the event of an inconsistency between the provisions of subpart C and the EFTA, the EFTA would prevail to the extent of the inconsistency.<sup>8</sup> Staff believes this provision is necessary in order to provide a clear, predictable, and comprehensive set of rules for all funds transfers over the FedNow Service, while being consistent with the EFTA.

Also like subpart B with respect to the Fedwire Funds Service, proposed new subpart C

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<sup>5</sup> UCC Article 4A provides comprehensive rules governing the rights and responsibilities of the parties to funds transfers. The rights and responsibilities covered in UCC Article 4A include those with respect to the receipt, acceptance or rejection, and execution of a payment order and settlement of a payment obligation; liability for the late, erroneous, or improper execution of funds transfers; the risks of loss associated with an unauthorized payment order; the obligation to pay for and the right to receive payment on a payment order; and the effect of payment by funds transfer on any underlying obligation between an originator and a beneficiary of a funds transfer.

<sup>6</sup> 15 U.S.C. 1693 *et seq.* The extent of the EFTA’s application to transfers over the FedNow Service would be a matter under the jurisdiction of the Consumer Financial Protection Bureau. In contrast to the FedNow Service, the Fedwire Funds Service is designed to serve primarily as a large-value funds transfer system between institutional users. The EFTA carves out from its scope wholesale payments, such as the Fedwire Funds Service, that are made over systems that are “not designed primarily to transfer funds on behalf of a consumer.” 15 U.S.C. § 1693a(7)(B).

<sup>7</sup> Section 4A-108.

<sup>8</sup> Conflicts between UCC Article 4A, which addresses interbank rights and obligations in a funds transfer, on the one hand, and EFTA and Regulation E, which address consumer protections, on the other, would be minimal.

grants the Reserve Banks authority to issue an operating circular for the FedNow Service, which would detail more specific terms and conditions governing the FedNow Service. Similar to subpart B, proposed new subpart C addresses various other issues related to the processing and settlement of funds transfers over the FedNow Service, including reliance on routing numbers to process payment orders by automated means, overdrafts in the accounts of participants in the service, rejection of payment orders by a Reserve Bank, and liability of Reserve Banks in connection with the processing of a payment.

While proposed subpart C governs the FedNow Service in a manner similar to the rules governing the Fedwire Funds Service in subpart B, a number of proposed provisions are tailored to the FedNow Service where it differs from the Fedwire Funds Service. In particular, the FedNow Service is designed for the end-to-end transfer to be completed in a matter of seconds, as described in the 2020 Notice. This aspect is reflected in proposed subpart C as a requirement that the beneficiary's bank must make funds available to the beneficiary immediately after it has accepted the payment order.<sup>9</sup> The NPR specifically requests comment on whether the Board should set out specific time parameters to clarify the meaning of "immediately" as used in this funds availability requirement and, if so, whether a timeframe of within seconds or, alternatively, within one minute after the bank has accepted the payment order would be reasonable.

This availability requirement would be a term of the FedNow Service between a Reserve Bank and a FedNow participant. Proposed subpart C would not provide a private right of action to a customer of the FedNow participant, or any party other than a Reserve Bank, with respect to any failure by the FedNow participant to satisfy the proposed subpart's availability requirement. Rather, the FedNow participant's customer relationship would continue to be governed by account agreements, UCC Article 4A, and the availability requirements of the Expedited Funds Availability Act (EFAA) and Regulation CC.<sup>10</sup> Regulation CC provides that funds received by a

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<sup>9</sup> The availability requirement is keyed to the beneficiary bank's "acceptance" of the payment order over the FedNow Service. The proposal would accommodate a feature of the FedNow Service under which the beneficiary's bank may notify its Reserve Bank that it requires additional time to determine whether to accept the payment order because it has reasonable cause to believe that the beneficiary is not entitled or permitted to receive payment, such as in instances when making funds available to the beneficiary may potentially violate applicable U.S. sanctions. The NPR specifically requests public comment on whether the regulation should allow for a beneficiary's bank to use this feature under a broader range of circumstances.

<sup>10</sup> UCC Article 4A provides that a beneficiary's bank is obliged to pay the amount of a payment order to the beneficiary on the payment date instructed by the sender. Section 4A-404(a).

bank by an electronic payment shall be available for withdrawal not later than the business day after the banking day on which such funds are received.<sup>11</sup> Although proposed new subpart C requires funds to be made available on a more prompt basis than the availability requirements of the EFAA and Regulation CC, the EFAA and Regulation CC requirements would continue to apply independently of proposed subpart C.<sup>12</sup>

Additionally, proposed subpart C would accommodate FedNow participants that choose to settle their activity over the service in a correspondent bank's master account with a Reserve Bank, rather than in their own master account with a Reserve Bank. (The Board indicated in the 2020 Notice that use of correspondent banks will facilitate access to the FedNow Service.)

Finally, as is the case with funds transfers over the Fedwire Funds Service, funds transfers over the FedNow Service would provide real-time settlement finality. Proposed subpart C provides that payment to a FedNow participant by a Reserve Bank is final at the earlier of the time when the amount of the payment order is credited to the FedNow participant's settlement account (which may be the participant's own master account or the master account of its correspondent bank) or the time when the Reserve Bank sends a conforming payment order to the FedNow participant. This payment would be final and irrevocable when made.<sup>13</sup>

### **Proposed Changes to Subparts A and B of Regulation J**

The NPR also proposes technical changes and clarifications to subpart B, including revisions to reflect the fact that the Reserve Banks will be operating a second funds transfer service. For example, the proposed amendments include clarifications with respect to subpart B's scope of application and modifications to the definitions of certain terms in subpart B. These proposed amendments are intended to clarify that the provisions of subpart B

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<sup>11</sup> 12 CFR 229.10(b). Staff is working with the Consumer Financial Protection Bureau to develop proposed revisions to Regulation CC to clarify its application to funds transfers over the FedNow Service.

<sup>12</sup> The proposed commentary to subpart C provides the following example: "if a beneficiary's bank accepts a payment order through the FedNow Service at 10 a.m. but does not make funds available to the beneficiary until 5 p.m., the bank has failed to satisfy its obligations under subpart C of this part even if it has satisfied its obligations under Regulation CC."

<sup>13</sup> This would not prevent FedNow participants from implementing procedures to resolve erroneous payments, or impede the ability of the receiving bank to initiate a new transfer to return funds in certain circumstances.

are limited to payment orders and parties to a funds transfer that are sent through the Fedwire Funds Service.

Additionally, the proposed amendments to subpart B would (i) update its existing provisions authorizing Reserve Banks to issue operating circulars consistent with the subpart in connection with the Fedwire Funds Service, and (ii) incorporate drafting enhancements from proposed new subpart C.<sup>14</sup> The proposed amendments to subpart B would further include minor changes to the existing provisions governing overdrafts in the account of Fedwire participants, to incorporate drafting enhancements from proposed new subpart C and to provide that the security interest that a sender grants to a Reserve Bank is with respect to all of the sender's assets in the possession or control of, or held for the account of, the Reserve Bank. Additional revisions are proposed to the commentary to that section to clarify its description of relevant UCC Article 4A provisions.

Finally, the NPR proposes technical corrections to subpart A of Regulation J to update cross-references to other regulations that are no longer current.

Attachment

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<sup>14</sup> The proposed revisions explicitly authorize Reserve Banks to issue operating circulars that also specify the time and method of receipt, execution, and acceptance of a payment order and settlement of a Reserve Bank's payment obligation for purposes of UCC Article 4A; specify service terms governing ancillary features of the Fedwire Funds Service (existing features, e.g., the FedPayments Manager); and provide for the acceptance of documents in electronic form to the extent any provision in UCC Article 4A requires an agreement or other document to be in writing.