

I. Background

On May 31, 2017, the Federal Reserve Board of Governors (“the Board”) issued final amendments to Regulation CC¹ (Availability of Funds and Collection of Checks) and the Official Staff Commentary (“commentary”) to encourage transition to a fully-electronic check payment system. In summary, the amendments affect electronic check forward collections and returns, electronically-created items, expeditious return and notice of nonpayment requirements, and create new warranties for remote deposit capture and electronically-created items. The final rule (“new rule” or “rule”) is effective July 1, 2018.

Final Rule in Brief

Regulation CC’s final rule reflects its transition to an electronic, image-based check collection and returns environment. Community banks should be aware of the following Regulation CC changes effective July 1, 2018:

- creates new definitions for electronic check, electronic returned check and electronically-created item;
- requires that both paper and electronic checks comply with a modified version of the “two-day test”;
- includes a new condition for expeditious-return liability;
- increases the amount required for the paying bank to provide notice of nonpayment to \$5,000 from \$2,500;
- revises the content requirements for the notice of nonpayment and notice in lieu of return; and
- adds a new indemnity to address liability for losses caused by remote deposit capture and by electronically-created items.

Link to the final rule: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170531a1.pdf>

II. Legal Framework

Generally, under this new framework: Subpart C of Regulation CC (“Reg CC”) applies to interbank electronic check exchange; the Check 21 Act supports substitute checks; and the Uniform Commercial Code and customer depositary agreements address remote deposit capture (“RDC”). Electronically-created items have no legal status under Reg CC.

¹ This final rule updates Subparts A, C, and D of Regulation CC, Availability of Funds and Collection of Checks (12 CFR part 229) which implements the Expedited Funds Availability Act of 1987 and the Check Clearing for the 21st Century Act of 2003.

III. Electronic Checks, Electronic Returned Checks and Electronically-Created Items

The final rule creates a new definition for electronic check and electronic returned check – “an electronic image of, and electronic information *derived from, a paper check or paper returned check*, respectively that (1) is sent to a receiving bank pursuant to an agreement between the sender and the receiving bank; and 2) conforms with ANS X9.100-1887, unless the Board by rule or order determines that a different standard applies or the parties otherwise agree.”² Moreover, under this definition an electronic forward presentment check includes data describing the original check, including MICR information, indorsements and front and back images; and an electronic returned check includes data populated from the forward presentment check and reason for return.

The rule contains a new definition for an electronically-created item (“ECI”) – “an electronic image that has all the attributes of an electronic check or electronic returned check but is created electronically and not from a paper check³. Typically, ECIs are created by companies creating images of their paper checks and sending the images to payees via email or other digital communication or using account information obtained from payors to create and deposit ECIs to obtain payment. Mobile applications are also available for consumers to create and send ECIs.

IV. Expeditious Return

Starting July 1, 2018, all returned checks, both paper and electronic are governed by a modified version of the “two-day test.” Under the test, checks must be returned in an expeditious manner such that the check would normally be received by the depository bank /bank of first deposit no later than 2 p.m. (local time of the depository bank) on the second business day following the banking day on which the check was presented to the paying bank.

The final rule also includes a new condition for expeditious-return liability to encourage the depository bank to accept electronic returned checks. The rule holds a paying bank/returning bank liable to a depository bank for failing to return a check in an expeditious manner only if the depository bank has arrangements in place allowing the paying bank or returning bank to return a check electronically, directly, or indirectly, by commercially reasonable means. Under this condition, the burden of proof is on the depository bank to demonstrate that its arrangements for accepting returned checks electronically are commercially reasonable.

V. Notice of Nonpayment and Notice in Lieu of Return

The rule increases the amount required for the paying bank to provide notice of nonpayment to \$5,000 from \$2,500. This notice must be received by the depository bank by 2 p.m. (local time of the depository bank) on the second business day following the banking day on which the check was presented to the paying bank. The notice

² Regulation CC Section 229.2(ggg)

³ Regulation CC Section 229.2 (hhh)

may be in the form of the returned check, a writing (includes a copy of the check), by telephone, Fedwire or any reasonable means.

The rule revises the content requirements for the notice of nonpayment and notice in lieu of return (only if check is unavailable for return) by no longer requiring the account number of the depositing customer, the branch name or number of the depository bank from its indorsement and the name of the paying bank. The new requirements include:

- bank name and routing number associated with depository bank indorsement,
- trace or sequence number associated with depository bank indorsement,
- payee name(s),
- amount,
- depository bank indorsement date, and
- reason for nonpayment.

The final rule also revises the commentary to note that notice in lieu of return is permitted only when a bank does not have sufficient electronic information/image to create a substitute check and by providing examples when notice in lieu of return is permissible.

VI. Warranties and Indemnification

Each bank transferring or presenting an electronic check or returned electronic check warrants to all banks in the forward presentment or returned check chain, the drawer and depositing customers that the image is an accurate representation of the front and bank of the original check at the time of truncation and that the check is not a duplicate presentment.⁴

The final rule adds a new indemnity to address liability when a depository bank receives a check through remote deposit capture.⁵ Under the new provision, a RDC depository bank indemnifies a depository bank accepting the original paper check for deposit because the RDC depository bank:

- permitted its customer to truncate the check,
- received settlement or other consideration for the check,
- did not receive a return of the check unpaid, and
- depository bank accepting paper check incurred a loss due to duplicate presentment.

⁴ Reg CC Section 229.34(a)

⁵ Reg CC Section 229.34 (f)

Additionally, a depository bank may not make an indemnity claim if the original paper check bears a restrictive indorsement inconsistent with the means of deposit.⁶

The rule includes new indemnities for electronically-created items or ECIs to protect indemnified banks for losses caused when (1) the account holder does not authorize the electronically-created item and (2) a subsequent bank pays an item previously paid.

Indemnity amounts are capped for ECIs and remote deposit capture checks so that the indemnity amount does not exceed the item settlement amount received by the indemnified bank and any interest and expenses of the indemnified bank. The indemnity amount may be reduced if the loss results from the indemnified bank's negligence or bad faith.

⁶ The indemnity exception prevents an indemnified bank from making an indemnity claim if it accepted an original check containing a restrictive indorsement that is inconsistent with the means of deposit, such as "for mobile deposit only." Reg CC Section 229.34(i)(3)