



FEDERAL RESERVE BANK  
OF DALLAS

WILLIAM H. WALLACE  
FIRST VICE PRESIDENT

March 8, 1985

DALLAS, TEXAS 75222

Circular 85-30

**TO:** The Chief Executive Officer of all  
depository institutions in the  
Eleventh Federal Reserve District

**SUBJECT**

**Regulation J - Amendment to improve the system of notification for  
nonpayment of checks of \$2,500 or more**

**DETAILS**

The Board of Governors of the Federal Reserve System has announced an amendment to Regulation J to strengthen the current requirement that payor depository institutions provide notice when they are returning unpaid large dollar checks presented through the Federal Reserve. The Federal Reserve's notification service also will be available to depository institutions for checks collected outside the Federal Reserve.

The Federal Reserve Bank of Dallas and its Branch Offices will continue to provide notification of nonpayment to the institution of first deposit under the terms and conditions of the Return Item pilot for the duration of the pilot. The Eleventh District also will make an enhanced notification service available to depository institutions for checks collected outside the Federal Reserve.

**ATTACHMENTS**

Attached are the Board's press release and the notice as published in the Federal Register.

**MORE INFORMATION**

For further information on the amendment, please contact the following individuals: Robert L. Whitman, (214) 698-4357 at the Head Office; Robert W. Schultz, (915) 544-4370 at the El Paso Branch; Vernon L. Bartee, (713) 659-4433 at the Houston Branch; or John A. Bullock, (512) 224-2141 at the San Antonio Branch.

Sincerely yours,

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

# FEDERAL RESERVE press release



For immediate release

February 8, 1985

The Federal Reserve Board today adopted an amendment to Regulation J, governing checks, to improve the system of notification for nonpayment of checks of \$2,500 or more that are processed through the Federal Reserve.

At the same time, the Board approved a proposal to improve notification services offered by the Reserve Banks as part of the check collection process. Both actions will become effective in October 1985.

The Board's action, in general, requires a depository institution upon which a large dollar check is drawn (payor institution) to notify the institution of first deposit within a specified time limit that it is returning the checks. To assist payor institutions in meeting this requirement, Reserve Banks will enhance their current notification service. An enhanced notification service will also be available to depository institutions for checks collected outside the Federal Reserve. A fee schedule, reflecting the estimated cost of providing these services, is outlined in the attached document.

The Board's notice is attached.

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Attachment

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**FEDERAL RESERVE SYSTEM**

**12 CFR Part 210**

[Docket No. R-0522]

**Federal Reserve Bank Check  
Collection System**

**AGENCY:** Board of Governors of the  
Federal Reserve System.

**ACTION:** Final rule.

**SUMMARY:** The Board of Governors has amended Regulation J to strengthen the current requirement that payor depository institutions provide notice when they are returning unpaid large dollar checks presented through the Federal Reserve. The amendment requires the payor institution to provide timely notice to the depository institution at which the check was originally deposited that the check is being returned unpaid. The Federal Reserve Banks will enhance the notification service they currently provide to assist payor institutions in meeting this requirement. The Federal Reserve's notification service will also be available to depository institutions for checks collected outside the Federal Reserve.

**EFFECTIVE DATE:** October 1, 1985.

**FOR FURTHER INFORMATION CONTACT:**  
Elliott C. McEntee, Associate Director (202-452-2231), or Bill Brown, Manager (202-452-3760), Division of Federal Reserve Bank Operations; Joseph R. Alexander, Attorney (202-452-2489), or Robert G. Ballen, Attorney (202-452-3265), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

**SUPPLEMENTARY INFORMATION:**

**Background**

Significant attention has recently been focused on the issue of delayed availability, that is, the practice of some depository institutions of delaying a depositor's ability to withdraw funds deposited by check for extended periods of time. Although the risk of loss to depository institutions associated with returned items is relatively small in the aggregate, many institutions point to the potential losses they could incur on particular returned checks as the reason

for their delayed availability policies. The Board, in conjunction with other federal banking regulators, has urged institutions to review their policies on making funds available to customers and to consider taking into account factors that indicate the degree to which a given situation presents a risk of loss. (See joint release of Federal Financial Institutions Regulators, March 22, 1984.) These factors include the length of time the account has been maintained, the past experience with the depositor, the identity of the drawer, the type of check, and the location of the payor institution. The Board recognizes that many institutions may be unwilling to modify their hold policies unless some effort is made to reduce what these institutions believe is their exposure to potential losses as a result of returned checks. The Board believes that, at this juncture, modification to the Federal Reserve's current requirement that payor institutions provide notification when they return unpaid large dollar checks appears to be an effective way of reducing risk to institutions of first deposit. This reduction in risk will permit depository institutions to reevaluate the length of their hold periods.

#### Current Requirement

Federal Reserve Bank operating circulars currently required a payor institution returning a check in the amount of \$2500 or more that has been presented to it by a Reserve Bank to provide a notification of nonpayment. This notice is usually given to the presenting institution, which is generally the Reserve Bank. When the Reserve Bank receives a notification from a payor institution, the Reserve Bank initiates a notification to the institution that sent the check to the Reserve Bank for collection.

The current procedure is not entirely satisfactory for several reasons. Payor institutions do not provide notification in all cases in which notification is required in part because the Federal Reserve has not indicated what liability an institution incurs if it fails to provide a notification. Moreover, there is no requirement that the payor institution notify the institution of first deposit directly that the check is being returned and the time period for providing notification is not specified. As a result, in some cases the returned check gets to the institution of first deposit at the same time as or before the notification. Finally, even when a timely notice is provided, it often does not contain enough information to be helpful to the institution of first deposit.

#### Proposed Notification Requirement

The Board proposed in June 1984 to amend Regulation J to improve the current notification requirement (49 FR 26597). Under the proposal, a payor institution that does not pay a check of \$2500 or more that had been collected through the Federal Reserve would be required to provide notice of nonpayment such that the notice is received by the institution of first deposit by midnight of the second banking day following the day on which the payor institution is required to dishonor the check. The notification would be required to include specific information provided the payor institution could determine the requisite information from the check. The payor institution could select among several means of providing notice, including providing notification by telephone or returning the check such that it is received by the institution of first deposit before the notification deadline. In this regard, the Reserve Banks would enhance their current notification service to assist payor institutions in meeting the notification requirement. (An enhanced Federal Reserve notification service would be available to depository institutions for all checks, including those collected outside the Federal Reserve. The Federal Reserve would, however, continue not to handle returned checks it did not originally collect.) A payor institution that failed to exercise ordinary care in providing timely and accurate notification could incur liability up to the amount of the item for resulting losses incurred by the institution of first deposit. In those cases where the Reserve Bank agreed to provide notification for the payor institution, the Reserve Bank would incur this liability rather than the payor institution. The process by which the physical item itself would be returned would not, however, be affected by this proposal.

#### Discussion and Analysis of Comments

Two hundred and sixty non-Reserve Bank comments were received in response to the Board's proposal, over 90 percent of which were from depository institutions. One hundred and fifty three (59 percent) of these commenters supported the proposal. Thirty, or approximately 60 percent, of the comments received from large correspondent depository institutions and 67, or approximately 78 percent, of the comments received from other depository institutions supported the proposal. Sixty four (25 percent) of the commenters opposed the proposal. The remaining 43 commenters (16 percent)

did not specify whether they favored or opposed the proposal.

Commenters favoring the proposal indicated that the proposal would, at minimal cost, result in a reduction in losses incurred by depositing institutions from returned checks and check kiting, as well as improve funds availability for customers of depository institutions. In this regard, 75 commenters, or 44 percent of the commenters commenting on this issue, reported that the proposal would enable depository institutions to improve their delayed availability policies because institutions would be able to protect themselves from potential losses on large dollar checks without imposing extended holds on all-check deposits.

Commenters opposing the proposal generally indicated that it would not result in improvements in availability because the notification requirement would apply only to checks collected through the Federal Reserve or because they do not currently delay availability. Accordingly, these commenters concluded that the cost of this proposal outweighed its benefits. Finally, many of these commenters stated that other approaches should be pursued, such as speeding up the return of the physical check through direct return to the institution of first deposit or automation of the return item process.

The Board believes that timely notification of nonpayment will enable the institution of first deposit to take steps to protect itself from potential loss. Such measures may include extending a hold it may have placed on the account or placing a hold on other funds of the depositor. The Board also believes that the proposal would provide significant public benefits by providing depository institutions the opportunity to make funds available sooner to their customers. Accordingly, the Board has determined to adopt the notification proposal.

Although the requirement would initially apply only to checks collected through the Federal Reserve, depository institutions may voluntarily extend notification to all checks of \$2,500 or more so as to simplify processing operations. In this regard, the Federal Reserve would make an enhanced notification service available to depository institutions for checks collected outside the Federal Reserve. Finally, the Board indicated that it would support legislation to extend the notification requirement to checks not originally collected through the Federal Reserve. (One hundred and twenty-seven commenters, or 85 percent of the



commenters commenting on this issue, strongly supported such legislation.)

The Board estimates that the proposal will be less costly to the banking industry compared to the current notification requirement. (The proposal will, however, result in modest cost increases for depository institutions that currently are not complying with the notification requirement.) The proposal will provide a number of cost savings as compared to the current notification requirement. The payor institution will not be required to provide notice for those checks that will be returned to the institution of first deposit within the notification deadline. Currently, a payor institution is required to provide notice for all large dollar returned checks collected through the Federal Reserve. Moreover, intermediary collecting institutions will realize cost savings because they will no longer be required to pass along notifications to their prior endorser. For these reasons, it is estimated that the proposal will reduce the number of required notifications for payor and intermediary institutions by half.

Several commenters suggested other alternatives to improve the return item process. While the Board expects the notification requirement to improve the return item process in the near term, it is recognized that this is an interim solution and further initiatives will be required to achieve long-term comprehensive solutions to the processing of return items. These initiatives are likely to include development and implementation of endorsement standards, assessment of technology to substitute automation for the largely manual handling of returns, and consideration of means other than telephone and wire to speed the flow of payment information. In this regard, the Dallas Reserve Bank has been experimenting with enhancements to its return item service that include returning unpaid checks directly to institutions of first deposit that are located in the Dallas Reserve Bank's District.<sup>1</sup>

The Federal Reserve will continue to take an active role in working with the industry and Congress to pursue improvements to the return item process.

Recognizing that some check processing equipment may not accommodate certain endorsement

standards and the difficulties of ensuring compliance with an endorsement standard, the Federal Reserve also intends to work with the industry to improve the quality of endorsements and implement endorsement standards. One hundred and twenty-nine commenters, or 91 percent of the commenters commenting on this issue, supported implementation of an endorsement standard to assist the payor institution in identifying, and providing notice to, the institution of first deposit.

#### Technical issues

**A. Scope of the notification requirement.** Under the Board's proposal, the notification requirement would apply to all cash items (e.g., checks), including items drawn on a Reserve Bank and items presented through a clearing house, in an amount of \$2,500 or more that were collected through the Federal Reserve. It is estimated that approximately one-third of all checks written are collected through the Federal Reserve. The proposal would not apply to items indorsed by, or for credit to, the United States Treasury.

One hundred and thirty one commenters, or 79 percent of the commenters commenting on this issue, agreed with the \$2500 cut off in the Board's proposal. The current notification requirement applies only to checks in amounts of \$2500 or more. Moreover, such checks account for over 50 percent of the dollars associated with returned checks but comprise only approximately 2 percent of all returns. For these reasons, the Board has determined that the notification requirement will apply only to checks in amounts of \$2500 or more. The impact of the \$2500 cut off will be evaluated over time to determine the feasibility of reducing the cut off. The same dollar cut off will apply to all returned checks, regardless of the reason for return, so as to avoid unduly complicating the notification requirement.

The Board believes that the exemption in the proposal for checks indorsed by, or for credit to, the United States Treasury should be adopted. Depository institutions typically do not delay availability of funds represented by checks indorsed by, or for credit to, the United States Treasury. Moreover, the Board believes that this exemption should be extended to checks drawn on the U.S. Treasury. Checks drawn on the U.S. Treasury are not returned for insufficient funds. Moreover, if such checks are returned for other reasons (e.g., forged endorsement), the return typically will occur long after the

expiration of any hold period imposed by the institution of first deposit. (Returned checks drawn on the U.S. Treasury are not subject to the Uniform Commercial Code's ("U.S.C.") time limits concerning return.) Accordingly, requiring notification of nonpayment of checks drawn on the U.S. Treasury serves little purpose because such notice would not be given in a time frame to be value to the institution of first deposit.

The Board believes that the notification requirement should apply to all other large dollar checks collected through the Federal Reserve. An exemption should not be provided for checks returned for improper indorsement, as suggested by six commenters, because such checks also represent a risk of loss to the institution of first deposit that notification of nonpayment could help avoid. For example, such a risk of loss could occur with an improperly indorsed check in the case where one joint payee attempts to obtain the funds represented by the check without the permission of the other joint payee(s).

**B. Time by which notification must be received by the institution of first deposit.** Under the Board's proposal, a payor institution would be required to provide notification of nonpayment such that it is received by the institution of first deposit by the second banking day following the day on which the payor institution is required to dishonor the check. That is, if a Reserve Bank presents a check to a payor institution on Monday, that institution would be required to determine whether to return the check by midnight Tuesday and would be required to provide a notification of return such that it is received by the institution of first deposit by Thursday.

Sixty nine commenters, or 44 percent of the commenters that commented on this issue, agreed with the Board's proposal. These commenters believed that this time period was necessary to accommodate internal operations and to permit the payor institution to take advantage of the most cost effective means of providing notice. Several of these commenters indicated that a shorter time period would result in operational problems, particularly for smaller depository institutions that return checks through the U.S. mail or have other entities (e.g., correspondent banks or processing centers) process their checks. On the other hand, 84 commenters, or 54 percent of the commenters commenting on this issue, believed that this time period should be shortened by one day. These commenters believed that it was

<sup>1</sup> As part of this pilot, the Dallas Reserve Bank currently is providing notification of nonpayment to the institution of first deposit. The Reserve Bank will continue to provide this notification under the terms and conditions of the pilot for the duration of the pilot.

feasible to provide the notification within the shorter time frame and that the sooner the institution of first deposit received notification, the greater the reduction in the loss exposure to depository institutions and the sooner funds could be made available to customers.

The Board has determined to adopt the proposed deadline in view of the operational considerations raised by a significant number of commenters concerning the shorter deadline. Accordingly, a payor institution that determines to return a check collected through the Federal Reserve is required to provide notification such that it is received by the institution of first deposit by the payor institution's *second* banking day following the day the payor institution is required to return the check. The Board indicated that it intends to evaluate this deadline over time to determine whether it could be shortened by one day after experience is gained with the notification requirement.

Under the Board's proposal, the deadline for receipt of notice would be established at midnight of the banking day, rather than at the institution of first deposit's close of business. Eighty three commenters, or 55 percent of the commenters commenting on this issue, agreed with the Board's proposal. These commenters indicated that they were accustomed to the midnight deadlines of the U.C.C. They stated that payor institutions could not be expected to be aware of the closing time of each institution of first deposit. Furthermore, a deadline based upon close of business (e.g., 2:00 p.m.) would give West Coast depository institutions only a few hours to provide same day notification to East Coast depository institutions. For these reasons, the Board has determined to require the payor institution to provide notice such that it is received by *midnight* of the second banking day following the day on which the payor institution is required to dishonor the check.

The Board believes that it is appropriate to base this deadline upon time of receipt by the institution of first deposit because it is that institution that would take this information into account in providing its customer with availability by a date certain. (In many cases, it would not matter whether the deadline is established in terms of the time the payor institution sends the notice or the time the institution of first deposit receives the notice because the day upon which the notice is sent by the payor institution and the day upon which it is received by the institution of first deposit will often be the same day.)

The Board expects that the institution of first deposit will establish procedures to ensure that the notification is brought to the attention of the individual(s) at the institution of first deposit responsible for receiving such notice as quickly as reasonably possible. Timely notification that otherwise satisfies the notification requirements would relieve the payor institution from liability with regard to the notice. The failure of the institution of first deposit to ensure that the notification is brought to the attention of the responsible individual(s), would not shift liability to a payor institution that otherwise satisfies the notification requirements.

*C. Day upon which notification is required is not a business day for the institution of first deposit.* Under the Board's proposal, if the day the payor institution provides notice to the institution of first deposit is not a business day for that institution, receipt of notice on the institution of first deposit's next business day would constitute timely notice.

One hundred and forty-five commenters, or 98 percent of the commenters commenting on this issue, agreed with the Board's proposal. These commenters indicated that the institution of first deposit would not release funds to its customers on a non-business day even if it received notice on that day. Accordingly, the Board has determined that if the day the payor institution is required to provide notice to the institution of first deposit is not a business day for the institution of first deposit, receipt of notice on the institution of first deposit's next business day constitutes timely notice.

Four commenters suggested that if the next business day for the institution of first deposit is not also a business day for the payor institution, the payor institution should not be required to provide notice until the next day that is a business day for both the payor institution and the institution of first deposit. It will be quite uncommon for the institution of first deposit's next business day to not also be a business day for the payor institution. In those rare instances where this day is not a business day for the payor institution, the payor institution could use another entity to provide notice on that day. In addition, the payor institution also would have the option of providing the notification to the institution of first deposit on the day prior to its closing. For these reasons, the Board has determined to require the payor institution to provide notice to the institution of first deposit on the institution of first deposit's next

business day, regardless of whether that day is also a business day for the payor institution.

*D. Information to be provided in the notification.* The Board's proposal required the payor institution to provide the following information: (1) The name of the payor institution; (2) the name of the payee; (3) the amount of the check; (4) the reason for return; (5) the date of the indorsement of the institution of first deposit; (6) the account number of the depositor; (7) the branch at which the check was first deposited; and (8) the trace number on the check of the institution of first deposit.

One hundred and six, or 97 percent of the commenters commenting on this issue, stated that the information specified in the Board's proposal would be useful to the institution of first deposit. Accordingly, the Board has determined that the payor institution is required to provide in the notification the information specified in the proposal provided it, exercising ordinary care and acting in good faith, is able to determine such information from the check itself. For example, the account number of the depositor, the branch at which the check was deposited and the trace number on the check could be provided in the notification only if the institution of first deposit had placed such information on the check. In those cases in which another entity provides notice for the payor institution, the payor institution would of course be required to provide that entity with information concerning the identity of the institution of first deposit.

Several commenters suggested additional information not included in the Board's proposal that would also be useful to the institution of first deposit. After evaluating these suggestions, the Board has determined to encourage, but not require, the payor institution to include the following information in the notification: (1) The drawer of the check (name and account number); (2) the number of the check; (3) the date of the check; (4) the last non-depository institution indorser if different from the payee; and (5) any other information that the payor institution believes might be useful to the institution of first deposit. The requirements as to the information to be included in the notification will be uniform among all Reserve Banks.

*E. Method of providing notification.* Under the Board's proposal, the payor institution could select among several means of providing notice, including providing notification by telephone or returning the check such that it is received by the institution of first



deposit before the notification deadline. Virtually all of the commenters commenting on this issue supported the options provided to the payor institution for satisfying the notification requirement.

Accordingly, the Board has determined to permit the payor institution to use any means to satisfy the notification requirement. For example, the payor institution could return the unpaid check such that it is received by the institution of first deposit by midnight of the second banking day following the payor institution's midnight deadline for dishonor of the check. This alternative would generally be feasible when the payor institution is returning a check to a nearby institution of first deposit, either directly or perhaps through a local clearing house. The payor institution could also itself provide a notification directly to the institution of first deposit. The notice could be given by telephone or other telecommunications networks such as BankWire, SWIFT, Telex or the Federal Reserve's Communications System, which would pass the message on to the institution of first deposit. The payor institution could also provide its Reserve Bank, such as by telephone, with all of the required information concerning the unpaid check. The Reserve Bank would then advise the institution of first deposit that the check is being returned and provide it with the appropriate information. For checks collected through the Federal Reserve, a payor institution could return the check to the Reserve Bank with instructions that the Reserve Bank initiate a notification to the institution of first deposit. The Reserve Bank would then provide the appropriate information on the check to the institution of first deposit.

Institutions exercising either of these latter two options will be required to provide the information or the check (as the case may be) to the Reserve Bank in advance of the time by which notification will have to be received by the institution of first deposit. These deadlines will be specified in the Reserve Banks' operating circulars.

In cases where the Federal Reserve initiated the notification or the payor institution initiated the notification through the Federal Reserve's Communications System, the notification would follow a standard format that will be developed well in advance of the implementation date. In addition, the Federal Reserve will work with the industry to develop a standard format for notifications that could be used regardless of whether the

notification is made through the Federal Reserve or through other means.

When the payor institution makes use of the Federal Reserve's notification service, the institution of first deposit will be able to specify to the Reserve Bank whether the institution desires to receive notification of dishonor via the telephone or the Federal Reserve's Communications System. The institution of first deposit will also be to specify the department (or other entity) that should receive the notice. Moreover, in those cases in which the Reserve Bank gives the notification, the Reserve Bank will retain documentation of the notification for the time period within which the institution of first deposit must initiate action concerning the notification of nonpayment and will provide this documentation to the payor institution upon request.

The Reserve Banks will develop procedures to ensure that they do not erroneously send a second notice in those cases in which the payor institution has itself provided notice and returned the check to the Federal Reserve for collection. For example, each Reserve Bank may require each payor institution in advance to notify the Reserve Bank whether the institution wants the Reserve Bank to provide notification on all or none of the institution's return items.

The Board proposed to charge the payor institution, rather than the institution of first deposit, for these enhanced notification services because the Reserve Bank is assisting the payor institution in fulfilling its responsibility to provide notification and because its customer is usually responsible for the returned check. Although the institution of first deposit does enjoy benefits from the notification, as asserted by a few of the commenters, the Board continues to believe it to be appropriate to charge the payor institution for the reasons indicated in the proposal.

The Board proposed that a three tiered fee structure apply to the services offered by the Reserve Bank. If the institution provides notification through the use of an on-line Fedwire message, a fee of \$2.25 per advice would be charged. This fee is based upon the estimated cost of providing the service, including any notification that the Reserve Bank must make by telephone to the institution of first deposit. If the payor institution provides the information, such as by telephone, to the Reserve Bank and requests it to provide the required information to the institution of first deposit, a fee of \$4.25 per advice would be charged. This fee reflects additional labor and other costs

involved in transcribing the information provided by the payor institution. Finally, if the payor institution returns a check collected through the Federal Reserve to the Reserve Bank with instructions to provide notification to the institution of first deposit, a fee of \$4.25 would be charged. This fee includes the costs of processing, reading the indorsements, initiating the wire advice, and other costs.

Five commenters stated that the Federal Reserve's fees should be cost-justified. As indicated above, the proposed fees are established to recover the projected cost of providing the service. These fees have been based upon projected volumes and experience with the cost of providing similar services. Accordingly, the Board has determined to adopt the fees as proposed. The Board intends to review these fees at the time it reviews the fee schedule for the Federal Reserve's check collection services and adjust the fees for the notification service, if necessary, to ensure that they continue to reflect the cost of providing the service. In the interest of maintaining a simple fee structure, the Board has determined not to adopt different fees depending upon whether the notification is being sent to an on-line or off-line institution as recommended by three of the commenters.

*F. Permitting or requiring institution of first deposit to specify to the payor institution the department or entity to receive notice.* Under the Board's proposal, the institution of first deposit would not be required to specify to the payor institution the department or entity to receive the notice. The Board's proposal was, however, silent as to whether the institution of first deposit would be permitted to specify to the payor institution this information.

Eighty one commenters, or 84 percent of the commenters commenting on this issue, opposed *requiring* the institution of first deposit to specify to the payor institution where notice should be sent. Sixty eight commenters, or 54 percent of the commenters commenting on this issue, opposed *permitting* the institution of first deposit to specify to the payor institution where notice should be sent. These commenters indicated that placing this information on the check would clutter the check and further complicate the reading of endorsements. These commenters stated that requiring the payor institution to look beyond the check for this information would be unduly complicated and costly, particularly in view of the rapid rate that this information would be updated and revised. Moreover, the institution of

first deposit should easily be able to route the notification to the appropriate area. For these reasons, the Board has determined that the institution of first deposit will not be required or permitted to specify to the payor institution the department of the institution (or other entity) that must receive the notification. Similarly, the Board believes that it is not necessary to specify in the regulation the area of the institution of first deposit to be notified (e.g., Return Item Unit).

As indicated above, the institution of first deposit would be able to specify to its Reserve Bank the department or entity to receive the notice. Similarly, a payor institution could agree with a particular institution of first deposit to provide the notice as directed by the institution of first deposit. The Board encourages bank directories to include information to assist the payor institution in providing notice.

*G. Institutions of first deposit located outside the United States.* Three commenters questioned how the notification requirement would apply if the institution of first deposit were located outside the United States. The Board believes that it would be an inordinate burden for the payor institution to provide notification to institutions of first deposit located outside the United States. Accordingly, in such cases, the payor institution should provide notification to the depository institution in the United States that first handled the item.

*H. Cancellation of a previous notification.* Five commenters raised questions concerning the case in which the payor institution provides notification but subsequently decides to pay the check. The Board has determined to adopt the suggestion of one of the commenters and require a payor institution that determines not to return a check subsequent to the provision of a notice of nonpayment to send a second notification as soon as reasonably possible cancelling its previous notification of nonpayment. This second notification should indicate that it is a second notification that is cancelling a previous notification of nonpayment. It should also contain sufficient information to enable the institution of first deposit to match this second notification with the previous notification of nonpayment.

*I. Liability for failure to comply with notification requirement.* Under the Board's proposal, a payor institution that failed to exercise ordinary care in complying with the notification requirement would be liable for losses incurred by the institution of first deposit up to the amount of the item if

the loss would have otherwise been avoided had the payor institution exercised ordinary care. A payor institution that failed to act in good faith (i.e., failure to exercise honesty in fact) in complying with the notification requirement would be liable for consequential damages. (These are the same liability standards as are contained in the U.C.C. Indeed, several courts already have applied this standard in cases involving the failure of a payor institution to provide notification of return.) Similarly under the proposal, in cases where the Reserve Bank assists the payor institution in providing notification, the Reserve Bank would be liable for a loss incurred by the institution of first deposit up to the amount of the item if the loss would have otherwise been avoided had the Reserve Bank exercised ordinary care in providing the notification. Accordingly, if the payor institution returns the check to the Reserve Bank in accordance with established deadlines and requests the Reserve Bank to initiate the notification, the Reserve Bank would incur the same liability to the institution of first deposit under the proposal as would the payor institution.

One hundred and forty commenters, or 93 percent of the commenters commenting on this issue, supported the Board's proposal. These commenters indicated that incorporating the same liability standards as are prescribed in the U.C.C. will result in the immediate application of an existing body of case law; thereby obviating the necessity of litigating the meaning of the language employed. Accordingly, the Board has determined to adopt the standards of liability as proposed.

Fourteen commenters suggested that the Board should specify how these standards of ordinary care and good faith would apply in the context of the notification requirement (e.g., should there be liability if the failure of the payor institution to provide notification was due to an act of God or computer down time). Regulation J currently provides a bank with an extension from the requirements in the regulation if the delay in complying is due to an interruption of communication facilities, war, emergency conditions or other circumstances beyond the bank's control. The Board does not believe that it would be appropriate to specify further how the standards of ordinary care and good faith would apply in particular factual circumstances because the factual circumstances cannot be anticipated prior to actual occurrences and this task is more appropriately performed by the courts.

The commenters were evenly split on whether the institution of first deposit, if it prevails in litigation, should be able to recover its court costs and reasonable attorneys' fees from the payor institution. The Board has determined that the institution of first deposit should be permitted to recover such costs to facilitate the recovery by the institution of first deposit of its economic loss (particularly for smaller institutions). However, so as not to unduly disadvantage the payor institution, the Board has adopted the suggestion of two commenters to permit the payor institution to recover its court costs and reasonable attorneys' fees if it prevails in litigation. (The costs of in-house counsel should be based upon the actual costs incurred by the party.)

Under the Board's proposal, only the payor institution would be required to provide notification of nonpayment. One commenter recommended that an institution to whom a check is presented for payment be required to provide notification even if that institution is not the payor institution. This commenter suggested that this would help alleviate the recent problem of MICR fraud (i.e., the intentional altering of a check so that it indicates one or more fictitious payor institutions in order that its collection and return be delayed beyond expiration of the institution of first deposit's availability of funds hold). The Board has determined not to adopt this suggestion because it would be unfair to impose this duty, and presumably liability for any failure to meet this duty, on an institution that is involved only because a malefactor identified the institution, without its consent or knowledge, as a party on the check. Similarly, intermediary collecting institutions would not have any responsibilities concerning the notification of nonpayment. This would be true even if an intermediary institution mistakenly receives a notification of nonpayment.

Four commenters raised the issue of whether the institution of first deposit is required to pass on the notification to its customer. The Board believes that this is an issue most appropriately left to agreement between the institution of first deposit and its customer given that the needs of each will vary from case to case. Accordingly, the rule adopted by the Board does not require the institution of first deposit to pass along the notification to its customer.

Several commenters raised questions concerning how the liability provisions of the notification requirement would overlap with existing requirements in the U.C.C. The Board believes that it



would be possible to have duplicative or overlapping liability if the payor institution failed to comply with the notification requirement and another depository institution failed to comply with the U.C.C.'s requirements concerning the return of the physical check. Similarly, the failure of the payor institution to satisfy the notification requirement should not defeat the claims that the institution otherwise would have against the institution of first deposit for breach of warranty.

One commenter asked what statute of limitations applied to the institution of first deposit's claim against the payor institution for failure to comply with the notification requirement. This question will be addressed separately in the context of Regulation J as a whole.

As discussed above, a Reserve Bank that provides a notification on behalf of the payor institution would incur the same liability as would be applicable to the payor institution had it itself provided the notification. Accordingly, the Board believes that it would be appropriate, as suggested by one of the commenters, for the Reserve Bank to indemnify the payor institution for any claim brought against it by the institution for first deposit that resulted from the Reserve Bank's failure to exercise ordinary care or failure to act in good faith in providing the notice. Similarly, the payor institution is to indemnify the Reserve Bank for any claim brought against it by the institution of first deposit that resulted from the payor institution's failure to exercise ordinary care or failure to act in good faith.

**J. Implementation date.** Several commenters indicated that a substantial lead time was necessary to establish procedures, train personnel, improve endorsements, and work for legislation to apply the notification requirement to all checks. Accordingly, the Board has determined that the new notification requirement be effective on October 1, 1985.

The impact of this amendment to Regulation J on small entities has been considered in accordance with the Regulatory Flexibility Act (Pub. L. 96-354; 5 U.S.C. 604). The amendment should not result in a significant burden on small depository institutions because all depository institutions currently are required to provide notification of nonpayment of checks of \$2500 or more collected through the Federal Reserve. That is, a payor institution currently is required to incur the cost of providing notice of nonpayment of such checks to the presenting institution. Under the amendment, a payor institution will be required to provide this notice of

nonpayment directly to the institution of first deposit rather than to the presenting institution. As discussed above, it is estimated that the proposal will reduce the costs for smaller payor depository institutions as compared to the current notification requirement by reducing the number of required notifications. Moreover, the Reserve Banks will provide an enhanced notification service which will reduce any operational effect this action may have. Finally, the amendment imposes no new reporting or recordkeeping requirements on depository institutions.

#### List of Subjects in 12 CFR Part 210

Banks, Banking, Federal Reserve System.

Pursuant to its authority under section 13 of the Federal Reserve Act, (12 U.S.C. 342); section 16 of the Federal Reserve Act (12 U.S.C. 248(o), 360); and section 11(i) of the Federal Reserve Act (12 U.S.C. 248(i)), the Board has amended 12 CFR Part 210 (Regulation J), effective October 1, 1985, as follows:

#### PART 210—[AMENDED]

In § 210.12, the last sentence of the section is designated as paragraph (d), and new paragraph (c) is added after paragraph (b) to read as follows:

##### § 210.12 Return of cash items.

\* \* \* \* \*

(c) *Notification of Nonpayment.* (1) A paying bank that receives a cash item in the amount of \$2500 or more directly or indirectly from a Reserve Bank and determines not to pay it shall provide notice to the first bank to which the item was transferred for collection ("depository bank") that the paying bank is returning the item unpaid. If the depository bank is not located in a state, the paying bank shall provide the notice to the bank located in a state that first handled the item for collection.

(2) The paying bank shall provide the notice such that it is received as specified by the operating circular of the paying bank's Reserve Bank by the depository bank by midnight of the second banking day of the paying bank following the deadline for return of the item as specified in paragraph (a) of this section. If the day the paying bank is required to provide notice to the depository bank is not a banking day for the depository bank, receipt of notice on the depository bank's next banking day shall constitute timely notice under this paragraph. Notice may be provided through any means, including return of the cash item so long as the cash item is received by the depository bank within

the time limits specified in this subparagraph.

(3) The information contained in the notice shall include the name of the paying bank, the name of the payee, the amount of the item, the reason for return, the date of the indorsement of the depository bank, the account number of the depositor, the branch at which the item was first deposited, and the trace number on the item of the depository bank, and should otherwise be in accordance with uniform standards and procedures specified by the operating circular of the paying bank's Reserve Bank. A paying bank is not required to provide any information in the notice that it, after exercising ordinary care and acting in good faith, is not able to determine with reasonable certainty from the item itself.

(4) A paying bank is not required to, but may voluntarily, provide notice to the department of the depository bank or other entity specified by the depository bank to receive the notice.

(5) If a paying bank provides a notice pursuant to subparagraph (1) of this paragraph and subsequently determines to pay the item, the paying bank shall provide to the depository bank a second notice as soon as reasonably possible. This second notice should indicate that it is a second notice that is cancelling a previous notice and should contain sufficient information to enable the depository bank to match the second notice with the previous notice.

(6) A paying bank that fails to exercise ordinary care in meeting the requirements of this paragraph shall be liable to the depository bank for losses incurred by the depository bank, up to the amount of the item, reduced by the amount of the loss that the depository bank would have incurred even if the paying bank had used ordinary care. A paying bank that fails to act in good faith in meeting the requirements of this paragraph may be liable for other damages, if any, suffered by the depository bank as a proximate consequence. If the paying bank or the depository bank prevails in litigation involving the requirements of this paragraph, it may recover its court costs and reasonable attorneys' fees. A paying bank shall not be liable for mistake, neglect, negligence, misconduct, insolvency or default of any other bank or other person in connection with providing notice under this paragraph.

(7) Notwithstanding the provisions of section 210.6 of this subpart, a Reserve Bank that fails to exercise ordinary care in undertaking to provide the notice required in this paragraph on a paying

bank's behalf shall be liable to the depositary bank for losses incurred by the depositary bank, up to the amount of the item, reduced by the amount of the loss that the depositary bank would have incurred even if the Reserve Bank had used ordinary care. A Reserve Bank that fails to act in good faith in undertaking to provide the notice required in this paragraph on a paying bank's behalf may be liable for other damages, if any, suffered by the depositary bank as a proximate consequence. If the Reserve Bank or the depositary bank prevails in litigation involving the requirements of this paragraph, it may recover its court costs and reasonable attorneys' fees. A Reserve Bank shall not be liable for mistake, neglect, negligence, misconduct, insolvency or default of any other bank or other person, including the paying bank in connection with providing notice under this paragraph.

(8) Notwithstanding the provisions of § 210.6 of this subpart, a Reserve Bank that undertakes to provide the notice required in this paragraph on a paying bank's behalf shall indemnify the paying bank for any claim brought against it by the depositary bank that results from the Reserve Bank's failure to exercise ordinary care or failure to act in good faith in providing the notice. The paying bank shall indemnify a Reserve Bank that undertakes to provide the notice required in this paragraph on the paying bank's behalf for any claim brought against the Reserve Bank by the depositary bank that results from the paying bank's failure to exercise ordinary care or failure to act in good faith in connection with the provision of the notice.

(9) This paragraph does not apply to an item drawn on the account of the U.S. Treasury or to an item indorsed by, or for credit to, the U.S. Treasury.

\* \* \* \* \*

By order of the Board of Governors.  
February 7, 1985.

William W. Wiles,

*Secretary of the Board.*

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