

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 9062]
May 1, 1981

REGULATION J

Proposed Technical Amendments

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

The Board of Governors of the Federal Reserve System has invited comment, by June 19, 1981, on proposed amendments to Subpart A, "Collection of Checks and Other Items," of its Regulation J, to implement portions of the Monetary Control Act of 1980 and to make certain technical changes. The following is quoted from the text of the Board's announcement:

The Monetary Control Act expanded eligibility for access to Federal Reserve collection of checks and other items to all depository institutions. The first of the Board's amendments would conform Regulation J to this change. In general, access to Federal Reserve services will begin when pricing for them starts, with check fees scheduled to be effective in August.

Enclosed—for depository institutions in this District—is the text of the Board's proposal. It will be published in the *Federal Register*, and copies will be made available upon request to our Circulars Division. Comments on the proposal may be sent to Carl W. Turnipseed, Manager of our Check Processing Department.

ANTHONY M. SOLOMON,
President.

Proposed Rules

Federal Register

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL RESERVE SYSTEM

12 CFR Part 210

[Docket No. R-0357]

Collection of Checks and Other Items and Transfer of Funds; Regulation J

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rules.

SUMMARY: The Board proposes to make several technical amendments to Subpart A of Regulation J, governing the collection of checks and other items by Reserve Banks, in order to implement the Monetary Control Act of 1980 and for other purposes. First, the proposal would define both a "sender" and a "bank" to include a depository institution as defined in section 19(b) of the Federal Reserve Act, as amended by the Monetary Control Act of 1980. Second, the proposal would impose upon a paying bank that returns an item an indemnity for loss or expense resulting from return of the item beyond the deadlines provided in the regulation. Third, the proposal would incorporate in Subpart A provisions for the collection of coupons and other securities similar to the provisions with respect to payment and return of cash items, other than the deadlines for payment and return. Fourth, the proposal would impose a warranty, and a related indemnity, upon a paying bank when it returns a cash item. The paying bank would warrant that it gave wire advice of nonpayment, if such wire advice was required by the Federal Reserve Bank operating circulars.

DATE: Comments must be received by June 19, 1981.

ADDRESS: Comments, which should refer to Docket No. R-0357, may be mailed to James McAfee, Assistant Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, D.C. 20551, or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments received may also be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

FOR FURTHER INFORMATION CONTACT: Lee S. Adams, Senior Counsel (202/452-3623), or Joseph R. Alexander, Attorney

(202/452-2489), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION: The following technical amendments to Subpart A of Regulation J, governing the collection of checks and other items by Reserve Banks, are proposed by the Board to implement the Monetary Control Act of 1980 and as technical improvements to the regulation. The Monetary Control Act amendment would extend access to Reserve Bank collection services to all depository institutions on an equal basis. The technical proposals generally strengthen and clarify the protections provided by the regulation to the senders of items and enable sending banks to make credit more readily available for cash items and securities deposited by customers for collection. The proposals do not impose additional operating burdens on paying banks with respect to either cash or noncash items. The four proposals are further described as follows:

1. *Expanded Access to Collection Services.* The Monetary Control Act of 1980 (Pub. L. 96-221, Title I) expands access to Reserve Bank check collection, wire transfer and other services to all depository institutions and requires that charges be imposed for such services. Expanded access and pricing for wire transfers of funds, governed by Subpart B of Regulation J, became effective January 29, 1981; amendments to Subpart B of Regulation J were not necessary to implement this expanded service. It is intended that expanded access for Reserve Bank automated clearing house services will be covered by a uniform operating circular to be issued by the Reserve Banks.

Expanded access and pricing for cash and non cash item collection services are currently scheduled for August and October of 1981, respectively, and the proposed amendments to Subpart A of Regulation J are intended simply to implement this expanded access by broadening the definition of "sender" in Subpart A to include a "depository institution" as defined in section 19(b) of the Federal Reserve Act. Charges for collection services are being published separately.

The proposed amendments would also clarify that the term "bank" includes a depository institution as defined in

section 19(b). The Consumer Checking Account Equity Act of 1980 (Pub. L. 96-221, Title III) authorizes depository institutions (as defined in 12 U.S.C. 1832(b)) to offer NOW accounts and credit unions to offer share draft accounts beginning December 31, 1980. The Board believes depository institutions (including credit unions) should be considered "banks", at least to the extent they offer third-party payment accounts equivalent to checking accounts, for purposes of Article 4 of the Uniform Commercial Code ("UCC") and Subpart A of Regulation J. If a depository institution is not a "bank" for purposes of Article 4 of the UCC and Subpart A, it would not have deferred posting rights and would have to pay or return items by the close of business on the day of presentment.

2. *Late Return of Cash Items.* Section 210.9 of Regulation J now provides that a paying bank is accountable for the amount of the cash item for which it has made provisional payment unless it returns the item within a specified time, generally referred to as the midnight deadline. Section 210.12 now provides that a paying bank warrants to the Reserve Bank and all other prior parties in the chain of collection that the paying bank returned a cash item in timely fashion. Section 210.12 also provides that the paying bank indemnifies the Reserve Bank for any loss or expense sustained (including attorney's fees and expenses of litigation) resulting from a breach of this paying bank's warranty. The proposal would extend the benefit of the indemnity by the paying bank to the sender and all parties prior to the paying bank, and would thereby conform the scope of the indemnity to the scope of the warranty of timely return.

In 1975, the Reserve Banks included in their cash item operating circulars a procedure whereby a sender could challenge the timeliness of return of an item by a paying bank, and this procedure was recently revised. The current procedure provides for the issuance of a certificate by the sender alleging late return by the paying bank and for the giving of a provisional credit by the Reserve Bank to the sender on the basis of that certificate. The provisional credit will be revoked if a Reserve Bank received from the paying bank, within 15 days after having sent the sender's certificate to it, a certificate by the paying bank that it did all that was necessary to return the item in a timely manner under Regulation J. Despite this procedure, sending banks continue to complain that paying banks sometimes return items in an untimely

manner. Sending banks also complain that it is not financially feasible to bring suit in a distant jurisdiction against the paying bank on the basis of an alleged untimely return, particularly where the amount of the item is rather small. The Board believes that if senders are indemnified by paying banks for attorneys' fees and expenses of successful litigation, they may be encouraged to enforce the timely return requirements, and payors might be less willing to assume the business risk of returning items late and breaching their warranty.

The Board also believes that this amendment and the recently revised procedure in the operating letters should enhance the ability of senders to rely upon returns being made within certain periods of time, depending upon the location of the paying bank with respect to the sender, and accordingly should permit senders to shorten the time by which they defer credit to their customers for items deposited. The regulatory provisions of course only apply to items handled by Reserve Banks.

3. *Handling of Coupons and Other Securities by Reserve Banks as Noncash Items.* In 1975, the Reserve Banks implemented the first phase of a reformation of their noncash collection operations by refusing to handle many noncash items other than securities (such as drafts drawn upon nonbank payors), and by requiring that coupons be enclosed in window envelopes for handling on a "said to contain" basis without examination of the coupons by the Reserve Banks. On October 1, 1979, the Reserve Banks implemented "cash" treatment of coupons and certain other securities by granting credit for these securities according to an availability schedule, subject to receipt of final payment from the payor. Thereafter, the Reserve Banks implemented automatic charge arrangements with payors, whereby the payors pay for such securities through a charge to an account on the Reserve Bank's books. These changes have resulted in the narrowing of differences between Reserve Bank handling of cash items (such as checks) and securities, which are classified as noncash items because they require special handling. For example, coupons and certain other securities, like cash items, now have credit given for them according to an availability schedule, rather than upon receipt of final payment as was formerly the case. In addition, these securities are now paid under automatic charge agreements, like cash items.

Because of the erosion of differences between cash items and security noncash items, the Board is proposing certain amendments to its Subpart A of Regulation J to parallel, with respect to securities, the provisions relating to payment and return of cash items. For example, it is proposed to amend § 210.9 to impose accountability upon the payor of a security for securities received by it unless it pays or returns the security within a stated deadline. The deadline for payment and return of securities, previously specified in Reserve Bank operating letters, has been the banking day following either the day of maturity of the security or the day on which the payor receives the security, whichever is later. This deadline is not changed and is carried over into the regulation. Similarly, § 210.12 is proposed to be amended to specify that the security must be returned by the payor prior to this deadline in order to avoid accountability and to recover any payment that may have been made under an automatic charge agreement. In addition, § 210.12 would be amended to provide that a Reserve Bank has no responsibility for determining whether a payor returned a security in timely fashion. The regulation would not specify the availability schedule for credit to sending banks for securities deposited for collection. Such availability schedules would continue to be found in the Reserve Bank operating letters as in the case of cash items. The Board believes that the proposed amendments are necessary in order to more clearly reflect the new operational reality. In addition the provisions would underline the responsibility of payors to pay or return within the specified deadline, and would provide for automatic charge as the expected means of payment by all payors of securities.

4. *Wire Advice of Nonpayment for Cash Items.* Currently, the Reserve Bank cash item operating letters, with certain exceptions, impose a uniform instruction calling for wire advice of nonpayment of cash items being returned for credit if the cash item is \$2,500 or more. The wire advice requirement is intended to speed up the notice of dishonor or nonpayment to the sender of the cash item, and is an additional requirement imposed upon the paying bank. The circulars do not make the paying bank accountable if wire advice is not given, and the courts (see *Bank of Wyandotte v. Woodrow*, 394 F. Supp. 550 (W.D. Mo. (1975))), have generally held that if wire advice is not given, damages may be recovered by the sender only if the damages would have been averted if wire advice had been given. With faster clearing by Reserve

Banks, the return item itself sometimes is received by the sender as soon as the wire advice is or would have been received, and as a result, a recent Bank Administration Institute report indicates that the giving of wire advice has declined to the point where paying banks give wire advice perhaps less than 50 percent of the time it is required. As is the case with monitoring timely return of cash items by paying banks, the Reserve Banks disclaim any responsibility for determining whether a paying bank has given wire advice of nonpayment, and the Reserve Banks give wire advice themselves only if they receive it from a paying bank.

The Board believes that it is important to encourage prompt notice to the sending bank of a return of a cash item. If the sending bank can be assured of obtaining prompt notice of nonpayment, it will be encouraged to shorten the time it defers credit to its customers for items deposited for collection. On the other hand, the Board believes that it is not feasible at this time to require paying banks to initiate wire advice directly to the depositing bank, or to require expedited handling of wire advice of nonpayment by banks in the collection chain. However, the Board does believe that paying banks should be encouraged to initiate wire advice, since the item itself may be delayed in return. Accordingly, the Board proposes to impose upon the paying bank a warranty that it has given wire advice when required, and an indemnity to the parties prior to the paying bank for loss and expense (including attorneys' fees and expenses of litigation) resulting from breach of this warranty by the paying bank. If this proposal is adopted, the Reserve Banks intend to modify their operating circulars to raise the minimum amount of a cash item for which advice is required from \$2,500 to \$5,000.

Regulatory Flexibility Act Analysis

The Board has considered the requirements imposed by the Regulatory Flexibility Act with respect to the impact of the rulemaking on small financial institutions. Due to the nature of Regulation J, the Board does not feel it could differentiate between large and small institutions in the regulation. Regulation J is an operating rule which governs the relationship between Reserve Banks and depository institutions utilizing Federal Reserve check collection and wire transfer services. The collection activities of the Reserve Banks closely resemble those of correspondent commercial banks. While Article 4 of the Uniform Commercial Code governs the rights and obligations of commercial banks handling items for collection, Regulation J both supplements and restricts the operation of Article 4 in defining the relationships, rights, and obligations of the Reserve Banks with respect to senders,

paying banks, nonbank payors and other organizations involved in the Federal Reserve collection process. Thus, the UCC and Regulation J are closely intertwined. Section 4-103(3) of the UCC gives contractual effect to the provisions of Regulation J and Reserve Bank operating circulars. Similarly, Regulation J contains provisions incorporating applicable State law, which in all States is the UCC. One of the central purposes of these bodies of law is to develop a uniform set of rules that institutions can rely upon with some degree of certainty as they exchange and collect commercial instruments, and the Board does not feel it can inject into this structure distinctions based upon the size of an entity. In addition, the amended rule will not impose additional reporting, recordkeeping, or other compliance burdens on such small businesses, and consequently the Board need not consider alternatives to the rule that would minimize its impact on small businesses. Where possible, the Federal Reserve intends to reduce operational burdens on all sizes of institutions. For example, if the amendment regarding wire advice of nonpayment is adopted by the Board, the Reserve Banks intend to modify their operating circulars to raise the minimum amount of a cash item for which advice is required in order to reduce the number of items to which the proposed amendment will apply. Finally, no other Federal regulations duplicate, overlap, or conflict with the proposed amended Regulation J.

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

1. In § 210.2, new paragraphs (b) and (k) are added and existing paragraphs (b) through (k) are revised and redesignated paragraphs (c) through (m), and reads as follows:

§ 210.2 Definitions.

As used in this subpart, unless the context otherwise requires:

(b) "Bank" includes a depository institution as defined in section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b)).

(c) "Bank draft" means a check drawn by one bank on another bank.

(d) "Banking day" means a day during which a bank is open to the public for carrying on substantially all of its banking functions, and, with respect to a nonbank payor, means a business day.

(e) "Cash item" means:

- (1) A check other than one classified as a noncash item under this section; or
- (2) Any other item payable on demand and collectible at par that the Reserve Bank of the District in which the item is

payable is willing to accept as a cash item.

(f) "Check" means a draft, as defined in the Uniform Commercial Code, that is drawn on a bank and payable on demand.

(g) "Item" means an instrument for the payment of money, whether negotiable or not, that is:

(1) Payable in a Federal Reserve District¹ ("District");

(2) Sent by a sender to a Reserve Bank for handling under this subpart; and

(3) Collectible in funds acceptable to the Reserve Bank of the District in which the instrument is payable.

Unless otherwise indicated, "item" includes both cash and noncash items. "Item" does not include a check that cannot be collected at par,² or an "item" as defined in § 210.26 that is handled under Subpart B.

(h) "Nonbank payor" means a payor of an item, other than a bank.

(i) "Noncash item" means an item that a receiving Reserve Bank classifies in its operating circulars as requiring special handling. The term also means an item normally received as a cash item if a Reserve Bank decides that special conditions require that it handle the item as a noncash item.

(j) "Paying bank" means:

(1) The bank by which an item is payable, unless the item is payable or collectible through another bank and is sent to the other bank for payment or collection; or

(2) The bank through which an item is payable or collectible and to which it is sent for payment or collection.

(k) "Security" means a bond, debenture, coupon, or similar evidence of indebtedness, that a Reserve Bank classifies as a noncash item. Security does not include an obligation of the United States or of its agencies or instrumentalities, or an obligation of an international organization paid by a Reserve Bank as fiscal agent.

(l) "Sender" means any of the following that sends an item to a Reserve Bank: a depository institution, a clearing institution, another Reserve Bank, an international organization, a foreign correspondent, or a branch or agency of a foreign bank maintaining reserves under section 7 of the

¹For purposes of this subpart, the Virgin Islands and Puerto Rico are deemed to be in the Second District, and Guam and American Samoa in the Twelfth District.

²The Board publishes a "Memorandum on Exchange Charges," listing the banks that would impose exchange charges on cash items and other checks forwarded by Reserve Banks and therefore would not pay at par.

International Banking Act of 1978. (12 U.S.C. 347d and 3105).

(1) "Depository institution" means a depository institution as defined in section 19(b) of the Federal Reserve Act. (12 U.S.C. 461(b))

(2) "Clearing institution" means:

(i) An institution that is not a depository institution, but maintains with a Reserve Bank the balance referred to in the first paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342); or

(ii) A corporation that maintains an account with a Reserve Bank in conformity with § 211.4 of this Chapter (Regulation K).

(3) "International Organization" means an international organization for which a Reserve Bank is empowered to act as depository or fiscal agent and maintains an account.

(4) "Foreign correspondent" means any of the following for which a Reserve Bank maintains an account: a foreign bank or banker, a foreign state as defined in section 25(b) of the Federal Reserve Act (12 U.S.C. 632), or a foreign correspondent or agency referred to in section 14(e) of that Act (12 U.S.C. 358).

(m) "State" means a State of the United States, the District of Columbia, Puerto Rico, or a territory, a possession, or dependency of the United States.

2. In § 210.9, new paragraph (b) is added and paragraphs (c) through (f) are redesignated and revised as follows:

§ 210.9 Payment.

(b) *Noncash Items—Securities*—A paying bank or nonbank payor becomes accountable for the amount of a security, received directly or indirectly from a Reserve Bank, at the close of the paying bank's or nonbank payor's banking day next following either the day of maturity or the banking day on which it received the security, whichever is later, if it retains the security after the close of that banking day, unless, prior to that time, it pays for the security by:

(1) Debit to an account on the Reserve Bank's books;

(2) Cash; or

(3) In the discretion of the Reserve Bank, any other form of payment.

The proceeds of any payment shall be available to the Reserve Bank by the close of the Reserve Bank's banking day. If the day for payment is not a banking day for the Reserve Bank, payment shall be made on the next day that is a banking day for both the Reserve Bank and the paying bank or nonbank payor.

(c) *Other noncash items*. A Reserve Bank may require the paying or

collecting bank to which it has presented or sent a noncash item, other than a security, to pay for the item in cash, but the Reserve Bank may permit payment by a debit to an account on the Reserve Bank's books or by any of the following that is in a form acceptable to the Reserve Bank: bank draft, transfer of funds or bank credit, or any other form of payment authorized by State law.

(d) *Nonbank payor*. A Reserve Bank may require a nonbank payor to which it has presented an item, other than a security, to pay for it in cash, but the Reserve Bank may permit payment in any of the following that is in a form acceptable to the Reserve Bank: cashier's check, certified check or other bank draft or obligation.

(e) *Handling of payment*. A Reserve Bank may handle a bank draft or other form of payment it receives in payment of a cash item as a cash item. A Reserve Bank may handle a bank draft or other form of payment it receives in payment of a noncash item as either a cash item or a noncash item.

(f) *Liability of Reserve Bank*. A Reserve Bank shall not be liable for the failure of a collecting bank, paying bank, or nonbank payor to pay for an item, or for any loss resulting from the Reserve Bank's acceptance of any form of payment other than cash authorized in paragraphs (a), (b), (c), and (d) of this section. A Reserve Bank that acts in good faith and exercises ordinary care shall not be liable for the nonpayment of, or failure to realize upon, a bank draft or other form of payment that it accepts under paragraphs (a), (b), (c), and (d).

3. Section 210.12 is revised to read as follows:

§ 210.12 Return of items.

(a) *Recovery of payment for cash items*. A paying bank that receives a cash item directly or indirectly from a Reserve Bank, other than for immediate payment over the counter, and that pays for the item as provided in § 210.9(a) of this subpart, may recover the payment if, before it has finally paid the item, it:

(1) Returns the item before midnight of its next banking day following the banking day of receipt; or

(2) Takes any other action to recover the payment within the times and by the means provided by State law.

(b) *Return of securities*. A paying bank or nonbank payor that receives a security directly or indirectly from a Reserve Bank may return the security, and recover any payment it has made for the item, if it returns the item before the close of the paying bank's or nonbank payor's banking day next following either the day of maturity or

the banking day on which it received the security, whichever is later.

(c) *Time for return*. The rules or practices of a clearinghouse through which the item was presented, or a special collection agreement under which the item was presented, may not extend the return times in paragraphs (a) and (b), but may provide for a shorter return time.

(d) *A paying bank's or nonbank payor's warranties and agreement*. A paying bank or nonbank payor that obtains a credit or refund for the amount of a payment it has made for a cash item or that returns a security:

(1) Warrants to the Reserve Bank, a subsequent collecting bank, and the sender and all prior parties, that it took all action necessary to entitle it to recover its payment or to return the security within the time limits of: (i) This subpart; (ii) for a cash item, State law, unless a longer time is afforded by this subpart; (iii) the rules or practices of any clearinghouse through which the item was presented; and (iv) any special collection agreement under which the item was presented;

(2) Warrants to the Reserve Bank, a subsequent collecting bank, and the sender and all prior parties, that it gave timely any wire advice of nonpayment required by the Reserve Bank's operating circular; and

(3) Agrees to indemnify the Reserve Bank, a subsequent collecting bank, and the sender and all prior parties, for any loss or expense sustained (including attorneys' fees and expenses of litigation) resulting from any breach of the warranty in § 210.12(d) (1) or (2).

A Reserve Bank shall not have any responsibility for determining whether the action taken by a paying bank or nonbank payor to return an item was timely, or whether wire advice of nonpayment was given by a paying bank.

By order of the Board of Governors, April 24, 1981.

James McAfee,

Assistant Secretary of the Board.

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