ACH Network Risk and Enforcement Topics
Request for Comment and Request for Information

Executive Summary and Rules Description
November 11, 2013

RESPONSES DUE BY MONDAY, JANUARY 13 2014

NACHA requests comment on a proposal to amend the *NACHA Operating Rules* (*Rules*) that is intended (i) to reduce the incidence of returned Entries, (ii) to reduce RDFI costs associated with handling consumer complaints and Return processing, and (iii) to improve overall network quality and customer satisfaction with the ACH process. The proposed modifications to the *Rules* are intended to be viewed in conjunction with other existing risk reduction tools, such as the National System of Fines and the existing process for enforcement actions, as well as a concurrent and complementary proposed Rule to improve ACH Network quality.[1]

NACHA also requests information on a separate topic as to whether, and how, the *Rules* should be modified to address debit Entries to business accounts by third parties to fund payrolls, when the ACH credit payments to employees are not completed.

Comments on this Request for Comment (RFC) and Request for Information (RFI) are due by Monday, January 13, 2014 at 5:00 p.m. Eastern Time.

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Part I: Proposal Summary

The proposed changes to the *Rules* described in this RFC are expected to improve the overall quality of the ACH Network by reducing the incidence of returned Entries and their associated costs, both financial and reputational, that such returned Entries impose on the ACH Network and its participants. These changes also are expected to increase customer satisfaction with the ACH Network by reducing the volume of transactions subject to customer dispute.

[1] See https://www.nacha.org/page/request-comment.

The approach to reducing risk in this proposal is two-fold. First, NACHA proposes to modify and tighten existing rules that provide guidance to ODFIs and Originators regarding acceptable origination practices. Within this category of changes, the *Rules* proposal would:

1. Reduce the existing return rate threshold for unauthorized debit Entries from 1.0 percent to 0.5 percent;

2. Expand the categories of return rate thresholds in the *Rules* to include a return rate threshold for account data quality returns at 3.0 percent, and an overall debit return rate threshold of 15.0 percent;

3. Clarify the limitations on the reinitiation of Returned Entries; and

4. Clarify the applicability of certain risk management rules to Third-Party Senders.

Second, the proposal would expand NACHA's authority to initiate enforcement proceedings for a potential violation of the Rules related to unauthorized Entries. The transmission of unauthorized Entries within the ACH Network has a particularly pernicious effect on ACH Network integrity, creating significant reputational issues for RDFIs and the Network as a whole. This change would give NACHA the authority to bring faster action against those ACH Network participants who introduce problematic transactions to the ACH Network by failing to obtain proper authorization in violation of the *Rules*.

Part II: Background and Rules Proposal Description

NACHA requests comment on the following proposed *Rules* changes.

A. *Return Rate Thresholds*

Background

The 2012 update to NACHA's ACH risk management strategy includes a focus on improving ACH quality. In connection with the risk management strategy update, NACHA engaged a payments industry consulting firm to analyze Returns for a 12-month period, which ended in the 2nd quarter 2012. This analysis demonstrated that Returns, particularly Returns for quality exceptions, continue to be a pain point for RDFIs. Each Return of an ACH Entry, regardless of cause, represents costs to the RDFI associated with handling a customer dispute and/or processing the Return and also often represents an unsatisfied customer. While some level of Returns is unavoidable, excessive or unusual patterns of returned Entries may be indicative of fraud or poor-quality origination. Poor quality origination may involve a number of factors, including improper authorization practices, participation of high-risk Originators, or low quality transaction/account information practices.

Although RDFIs are the ACH participants that bear the bulk of the costs associated with Returns, they are the participants with the least ability to influence the reduction of Returns resulting from poor quality origination practices. Low quality origination practices can be best addressed by the ACH participants responsible for originating Entries in the ACH Network. Therefore, the proposed rules are aimed at improving the origination practices of ODFIs and their Originators and Third-Party Senders, thereby increasing the quality of Entries entering the ACH system (e.g., by lowering the likelihood that the Entry will be returned).

More specifically, the findings of NACHA's consultant, which are quoted in relevant detail in the concurrent Request for Comment regarding ACH Network Quality,[2] identify two categories of return codes – Returns for authorization issues and Returns for account data issues – that make up the majority of quality-related Returns. The proposed *Rules* modifications include changes to reduce the frequency of these two quality-related Return categories.

Moreover, while some level of Returns, including for funding-related issues such as insufficient funds or frozen accounts, may be unavoidable, excessive total Returns also can be indicative of problematic origination practices. For example, although some industries have higher average return rates because they deal with consumers with marginal financial capacity, even within such industries there are outlier Originators whose confusing authorizations result in high levels of Returns for insufficient funds because the Receiver did not even understand that s/he was authorizing an ACH transaction. Although such an Entry may be better characterized as "unauthorized," as a practical matter it may be returned for insufficient funds before a determination regarding authorization can be made. Regulatory and enforcement agencies continue to cite total return rates as a relevant factor in targeting improper origination practices. As a result, the proposed Rules modifications also include changes designed to reduce the overall frequency of Returns.

Unauthorized Debit Threshold

NACHA's risk management strategies have previously focused significant attention on reducing unauthorized debits, including by establishing a return rate threshold at one percent for unauthorized debits. Although these strategies have proven successful in the past at reducing levels of unauthorized debits,[3] the decline in the unauthorized debit rate has leveled off, with the rate of 0.03 percent in calendar year 2012 being identical to that of 2010. Further, the absolute number of unauthorized debits is once again rising along with ACH volume.

Returns for authorization issues are characterized as Returns due to a problem with authorization, including unauthorized, revoked authorization, stopped payments or RDFI customer disputes. Although the authorization-related return rate for ACH entries is lower than reported fraud rates for credit cards (0.07 percent) and signature debit cards (0.06 percent),[4] unauthorized debits at any rate remain a significant source of cost and other harm to RDFIs and Receivers as well.

In April 2011 NACHA circulated a Request for Comment, but did not ballot, a proposal to reduce the return rate threshold for unauthorized debit entries to 0.5 percent incrementally over time. Comments in response to the prior proposal were generally supportive to the reduction of the return rate threshold, but were less certain at that time about reducing the rate to as low as 0.5

[2] See https://www.nacha.org/page/request-comment.
[3] These efforts resulted in an overall unauthorized debit rate decline (Return Codes R05, R07, R10 and R29) from 0.06 percent (i.e., 6 out of 10,000 debits) in 2005 to 0.03 percent in 2012. Further, the number of unauthorized debits in the ACH Network fell from 3,060,774 in 2005 to 2,942,349 in 2012.
[4] These figures were provided by the payments consulting firm referenced on Page 2.

percent. Over the past two years, however, concern about unauthorized transactions and high risk origination practices and their adverse impact on RDFIs and the ACH Network has increased. Some ACH participants that were previously uncertain whether the benefits of imposing such a decrease would outweigh the costs more recently have expressed an interest reducing the unauthorized return rate threshold to this level and implementing additional return rate thresholds as well. Therefore, NACHA believes that it is appropriate at this time to reconsider a reduction in the return rate threshold for unauthorized debit Entries.

Specifically, the proposed rule would reduce the current return rate threshold for unauthorized debit Entries (Return codes R05, R07, R10, R29, R37 and R51[5]) from 1 percent to 0.5 percent. This revised threshold is itself more than 16 times higher than the average Network return rate for unauthorized debit Entries for calendar year 2012. NACHA believes that unauthorized debit returns at this level would still indicate problematic origination practices, and therefore would be a useful tool to enable NACHA to expand its risk investigations efforts while still focusing on likely high-risk activity.

Data Quality Threshold

Returns due to incorrect account data or a problem with the account, including invalid account numbers and inability to locate the account (i.e., “account data issues”), are more common than Returns for unauthorized Entries and are more likely to have occurrences that are difficult to completely avoid. However, a high level of Returns for account data quality issues generally is indicative of questionable origination practices or high risk activities. For example, an online Originator that fails to adopt simple requirements for Receivers to re-enter routing and account information to help avoid typographical errors can create significant volumes of Returns and impose significant costs on RDFIs that could be easily avoided through better origination practices.

Account data quality issues were identified by NACHA’s consultant as the most widespread cause of ACH quality exceptions, occurring at a rate of 0.28 percent of ACH debit Entries originated during the period studied by NACHA’s consultant. In light of the problems created by account data quality issues, in April 2011 NACHA circulated a Request for Comment, but did not ballot, a proposal to establish a return rate threshold for invalid account information. As with the unauthorized return rate proposal, NACHA has been approached by ACH participants who believe that the continued occurrence of these types of Returns within the Network warrant stronger action at this time.

As a result, this proposed Rule would establish a return rate threshold for debit Entries for account data quality issues (Returns with reason codes R03 and R04) at 3.0 percent. This threshold is more than 16 times higher than the recent average ACH Network return rate for account data issues. As with the proposal for the unauthorized debit threshold, NACHA believes that Returns for account data issues at this level are indicative of problematic origination practices, and that this threshold would be a useful tool to enable NACHA to expand its risk investigations efforts while still focusing on likely high-risk activity.

[5] The proposed Rule would add R37 within the scope of the unauthorized threshold.

Total Return Threshold

Finally, experience indicates that even if Returns of unauthorized Entries and Returns for account data issues are within tolerances, problem Originators can still impose significant costs on the system through other types of Returns. Of course, the tolerance for total Returns must be greater because there are many legitimate reasons why Returns may occur, including whether the Receiver has insufficient funds. Moreover, it is not the intent of the Rules proposal to completely foreclose the use the ACH Network for payments within industries that may tend to deal with lower-income customers who are more likely to experience an insufficient funds scenario. Nonetheless, even within such industries there are Originators whose return rates far exceed any reasonable expectation. During the period studied by NACHA's consultant, the total debit return rate within the ACH Network was approximately 1.5 percent. Therefore, the proposed Rule would establish an overall debit return rate threshold for all debit Entries, for all return reason codes, at 15 percent. By setting the threshold at approximately 10 times the ACH Network average, NACHA believes that sufficient leeway will be permitted for businesses that attempt to service high risk communities without creating return rates that significantly increase costs on RDFIs and raise questions about the quality of the origination practices.

Consequences of Failing to Satisfy a Threshold

NACHA is not proposing any change to the measurement period for calculating threshold compliance (two months or 60 days) or to the consequences of failing to satisfy a return rate threshold. An ODFI that has an Originator or Third-Party Sender that hits one of the new thresholds would be subject to the same consequences currently set forth in the *Rules* for the existing return rate for unauthorized debits. Specifically, an ODFI that has an Originator or Third-Party Sender that hits a threshold would required to (i) respond to a NACHA inquiry regarding its return rates, addressing whether or not a threshold has been exceeded, and if so, the reason for the breach of the applicable threshold, (ii) provide additional reporting to NACHA, including a detailed plan and timeline for reducing the return rate below the applicable threshold within 30 days, and (iii) actually bring the return rate below the applicable threshold within 30 days and maintain the threshold for 180 days.[6] ODFIs with Originators or Third-Party Senders with return rates in excess of the thresholds also would be subject to the *Rules* enforcement process, including possible sanction for a Class 2 *Rules* violation.

Specific Request for Comment

NACHA intends to set the return rate thresholds at levels that are not so high that they fail to identify unnecessarily high-risk Origination practices, or so low that they catch most businesses in industries that experience higher than normal return rates as a matter of course due to the financial capacity of their receivers or other legitimate factors that may affect return rates generally. NACHA seeks comment on whether the proposed return rate thresholds are reasonable, or whether they are either too high or too low.[7] If a commenter believes any of the

[6] See Subsection 2.17.2.

[7] NACHA has previously received comments in response to past proposed rules about the potential for return rate thresholds to unduly impact small Originators. As an example, an Originator that initiates 100 debits and has 1 returned as unauthorized would hit the 1 percent return threshold. While this is technical true, the practical effect is that it is extremely unlikely that this level of return activity would be reported to NACHA.

proposed return rate thresholds should be set at a level other than as proposed, NACHA requests that the commenter propose a more appropriate return rate threshold, explain the rationale for the alternative level, and provide data and information to support the alternative threshold.

The proposed return rate thresholds apply only to Returns of debit Entries since these are more likely to result in a Return for lack of authorization or account data issues. However, NACHA understands that some high-risk Originators may use credit Entries to attempt to verify account information that may later be used in connection with an unauthorized debit Entry. In addition to seeking comments on these proposals, NACHA seeks comment on whether separate ODFI Return Rate Reporting thresholds should be established for Returns of credit Entries with regard to account data quality return rate or the overall return rate.

Proposed Effective Date: March 20, 2015.

B. *Reinitiation*

Reinitiation is the method permitted in the *Rules* by which a Returned Entry may be resubmitted. To restrict the frequency of additional Returns, the *Rules* currently permit Entries to be reinitiated only under limited circumstances and in compliance with specific requirements. Specifically, the *Rules* currently permit reinitiation of a Return if:

- An ACH debit was returned for reasons of insufficient or uncollected funds (as denoted by the return codes R01 and R09, respectively). In such a case, the Entry may be reinitiated a maximum of two times in an attempt to collect funds;
- An ACH debit was returned because of a stop payment order (return code R08), and reinitiation has been separately authorized by the Receiver after the stop payment order was given; or
- An ACH entry was returned for another reason, and the Originator or ODFI has corrected or remedied the reason for the Return (for example, an error in an account number is correct).

In any of these circumstances, reinitiation must take place within 180 days of the Settlement Date of the original Entry. After the expiration of this 180-day period, any additional action on, or resolution of, a returned Entry must take place outside the ACH Network.[8]

NACHA has reason to believe that some high-risk Originators may ignore or attempt to evade the requirements of the Reinitiation Rule, including by changing content in various fields to make an Entry appear to be a new Entry, rather than a reinitiation. In response, in July of this year, NACHA issued ACH Operations Bulletin #3-2013 titled "Reinitiation of Returned Debit Entries"[9] in an attempt to clarify that various types of Entries used by such high risk Originators are indeed "reinitiated" Entries and therefore already are restricted, and in some cases prohibited, by the existing Reinitiation Rule. Nonetheless, in order to leave no ambiguity in this regard, NACHA proposes to formally incorporate into the *Rules* several clarifying changes to the Reinitiation Rule consistent with the principles set forth in Operations Bulletin #3-2013.

[8] See Subsection 2.12.4.
[9] See https://www.nacha.org/OpsBulletins.

Most fundamentally, Subsection 2.12.4 of the *Rules* implicitly prohibits the reinitiation of Entries outside of the express limited circumstances under which they are permitted under the *Rules*. The proposed rule would make this prohibition explicit. For additional clarity, NACHA proposes to include in the Reinitiation Rule common examples that would be considered reinitiating an Entry to avoid arguments, for example, that adding a fee to an Entry creates a new Entry or that attempting to resubmit for a lesser amount takes the Entry outside of these limitations. To leave no doubt on a critical point, the proposal would add a specific prohibition against reinitiating a transaction that was returned as unauthorized. These examples are not intended to be exhaustive, but rather are illustrative. The proposed Rule would further include an anti-evasion provision, specifying that any other Entry that NACHA reasonably believes represents an attempted evasion of the foregoing limitations would be treated as an improper reinitiation.

To avoid unintended consequences from these clarifications, NACHA also proposes to include in the Reinitiation Rule two categories of Entries that would not be considered reinitiations. First, the proposal would clarify that a debit Entry in a series of preauthorized recurring debit Entries will not be treated as a reinitiated Entry, even if the subsequent debit Entry follows a returned debit Entry, as long as the subsequent Entry is not contingent upon whether an earlier debit Entry in the series has been returned. By way of example, if a consumer arranges for his or her minimum payment on a credit card balance to be paid monthly from an account based on a single preauthorization, and the consumer's debit Entry for the September minimum payment is returned for insufficient funds, the debit Entry for the October minimum payment would not be considered a reinitiation of the debit Entry with respect to the returned September Entry.

Second, NACHA proposes to expressly state that a debit Entry will not be considered a "reinitiation" if the Originator obtains a new authorization for the debit Entry after the receipt of the Return. The existing Reinitiation Rule already makes a reference in this regard to Entries that are returned due to stop payment orders, but the proposal would broaden the scope of the exception since a new authorization should always be considered to create a new Entry. For example, if an Originator attempts to represent an Entry returned as NSF twice, but the customer later deposits funds to the account and authorizes the Originator <u>at that time</u> to debit the account, the Originator should be permitted to do so. The timing requirement is important, however, since Originators will <u>not</u> be permitted to obtain advance approval to debit an account in a manner that would otherwise violate the Reinitiation Rule.

Consistent with ACH Operations Bulletin #3-2013 "Reinitiation of Returned Debit Entries," the proposed rule would require a reinitiated Entry to contain identical content in the following fields: Company Name, Company ID, and Amount. Further, the proposed rule would permit modification to other fields only to the extent necessary to correct an error or facilitate processing of an Entry. This change will allow reinitiations to correct administrative errors, but would prohibit reinitiation of Entries that may be attempts to evade the limitation on the reinitiation of returned Entries by varying the content of the Entry.

Finally, the proposal addresses two technical issues associated with the Reinitiation Rule. First, NACHA proposes to require the ODFI to include the word "REDEPOSIT" in the Company Entry Description field to identify Entries that are permissible resubmissions of Returned Entries under the Reinitiation Rule. Use of the word "REDEPOSIT" in the field would notify the

Receiver that the Entry relates to a previously Returned Entry, and will facilitate research and dispute resolution for RDFIs. Second, there is not currently a separate Return code for an RDFI to indicate when an Entry is being returned for a violation of the Reinitiation Rule. NACHA proposes to allow such returns to use Return code R10 (currently used for Extended Returns) to include a Return for a violation of the Reinitiation Rule (Subsection 2.12.4), since most violations of the Reinitiation Rule are likely to be identified via customer complaint after the expiration of the "two-day" return timeframe (i.e., an extended return timeframe would be necessary).

Specific Request for Comment

In addition to comments on the proposed changes to the Reinitiation Rule, NACHA specifically requests comment on one implication of the use of the R10 code to Return an Entry that violates the Reinitiation Rule. In general, an RDFI is required to obtain a Written Statement of Unauthorized Debit when returning an Entry under the R10 Return code. However, it is not clear that it would make sense to require a new Written Statement of Unauthorized Debit in connection with a violation of the Reinitiation Rule. For example, if an RDFI Returns an Entry as unauthorized, it would already have a Written Statement of Unauthorized Debit on file with respect to the original Entry; obtaining a second would seem to place an additional burden on the RDFI and affected customer without much benefit. Similarly, it seems excessive to require a Written Statement of Unauthorized Debit if a customer calls to complain that there have been four attempts to debit his/her account for the same transaction. Accordingly, NACHA requests comment as to whether to there should be an exception to the Written Statement of Unauthorized Debit for some or all Returns due to violation of the Reinitiation Rule.

Proposed Effective Date: March 20, 2015.

C. *Third-Party Senders*

Subsection 2.2.2 of the *Rules* currently requires ODFIs to establish, implement, periodically review and enforce exposure limits for its Originators and Third-Party Senders. In particular, the ODFI is required to monitor each Originator's and Third-Party Sender's origination and return activity across multiple Settlement Dates, enforce restrictions on the types of Entries that may be originated and enforce the exposure limit. Moreover, if an ODFI enters into a relationship with a Third-Party Sender that processes Entries such that the ODFI itself cannot or does not perform these monitoring and enforcement tasks with respect to the Originators serviced by the Third-Party Sender, the Third-Party Sender must do so. For example, Subsection 2.15.3 provides:

> To the extent that a Third-Party Sender performs any of the obligations of an ODFI under these Rules, the Third-Party Sender must perform the requirements of these Rules otherwise applicable to the ODFI, and warrants that it is legally able to do so. The performance by a Third-Party Sender of any of the obligations of the ODFI under these Rules shall not relieve the ODFI of any of its obligations under these Rules.

It has come to NACHA's attention that, regardless of the breadth of the obligation of Third-Party Senders at Subsection 2.15.3, without a specific cross-reference to Subsection 2.2.2, some Third

Party Senders may not be monitoring, assessing and enforcing limitations on their customer's origination and return activities in the manner intended by the *Rules*. To emphasize the importance of this function, without imposing any new duties, NACHA proposes to include a direct obligation on Third-Party Senders to monitor, assess and enforce limitations on their customer's origination and return activities in the same manner the *Rules* require of ODFIs.

In addition, NACHA proposes to update certain reporting requirements in the *Rules* in order to streamline oversight of Third-Party Senders. Section 1.2.2 and Appendix Eight of the Rules require each Third-Party Service Provider and Third-Party Sender that has agreed with a Participating DFI to process Entries to annually conduct, or have conducted, an audit of its compliance with the Rules. Part 8.1 of Appendix Eight requires the Third-Party Service Provider or Third-Party Sender to provide documentation supporting completion of the audit to the National Association upon request. However, since the ODFI is the direct ACH participant that provides Third-Party Service Providers and Third-Party Senders access to the ACH Network, it would streamline NACHA's oversight role if NACHA were able to obtain proof of such audit from the relevant ODFI, rather than from individual Third-Party Service Providers and Third-Party Senders. Therefore, NACHA proposes include a new provision in Part 8.1 of Appendix Eight that would allow NACHA to request from ODFIs, and require ODFIs to provide, documentation supporting completion of their Third-Party Service Provider and Third-Party Sender audits upon request of NACHA. The provision would also obligate the Third-Party Service Provider or Third-Party Sender to provide such proof of completion to the ODFI in order to fulfill a request from NACHA.

Proposed Effective Date: September 19, 2014.

D. *Expansion of NACHA's Enforcement Authority*

Under Subpart 10.2.2 of Appendix 10 of the *Rules*, NACHA has the authority to initiate a *Rules* enforcement proceeding under the following three circumstances: (1) if an ODFI fails to timely provide upon NACHA's request complete and accurate information regarding return rate reporting; (2) the ODFI substantiates that an Originator or Third-Party Sender has exceeded the return rate thresholds and fails to reduce the return rate under the threshold within 30 days; or (3) the ODFI substantiates that an Originator or Third-Party Sender has exceeded the return rate thresholds reduces the return rate under the threshold within 30 days but fails to maintain the return rate under the threshold for 180 days. All other enforcement proceedings must be triggered by a specific request of a Participating DFI.

Thus, even when an ODFI supports multiple Originators that are engaged in improper authorization practices, NACHA must wait for specific claims to be asserted by Participating DFIs before taking action. As explained earlier, Originators of unauthorized Entries are a key cause of quality-related Returns and adverse impacts on the reputation of the ACH Network and RDFIs. In the current environment where RDFIs and NACHA itself have been blamed for the actions of others, it has become increasingly important that NACHA have the tools to act promptly for the protection of the integrity of the ACH Network and all its participants. As a result, NACHA proposes to amend the *Rules* to include the express authority to bring an enforcement action based on the origination of unauthorized entries.

In addition, because NACHA remains reliant on Participating DFIs and Operators to identify potential *Rules* violations in the first instance, NACHA encourages RDFIs to voluntarily provide to NACHA information, such as return data, that may be indicative of a potential *Rules* violation by other ACH Network participants, including improper authorization practices, even if the RDFI is not interested in itself initiating a *Rules* enforcement proceeding. Such cooperative information sharing can be helpful in reducing the adverse impact of high risk activity in the ACH Network. While this would not give NACHA the authority to initiate an enforcement action outside of the limited circumstances identified above, early sharing of information regarding unusual return rates or unauthorized transactions can help head off improper activities more quickly. NACHA proposes to make express reference to its ability to use such information during enforcement proceedings in order to remind Participating DFIs of the importance of their cooperation, both formal and informal, in the process.

Proposed Effective Date: September 19, 2014.

Part IV: Impact of the Proposed Rule

Each of the proposals described above is anticipated to have the following benefits and costs to NACHA and ACH Network participants. The unique benefits and costs that are expected to affect a class of ACH Network Participants are described following the general costs and benefits.

General Benefits of the Proposed Rule

NACHA and all ACH Participants: Each of the Rules described in this RFC is expected to benefit the ACH Network by either reducing and/or mitigating the risks associated with conducting transactions through the ACH Network. By reducing and mitigating such risks, the ACH Network and each of its participants are expected to benefit from the strengthened security and integrity of the ACH Network and the transactions processed through it. Further, such Rules would act to prevent and reduce potential reputation and financial losses associated with such risks.

Specific Benefits and Costs to Comply with the Proposal for ACH Network Participant Classes

<u>Reduced and New Return Thresholds</u>

All Participants: NACHA expects all ACH Network participants to benefit from the reduction of the return rate threshold for unauthorized debit entries, and the addition of return rate thresholds for account data quality issues and overall returns. These reduced and new return rate thresholds are expected to cause ODFIs to focus on reducing the number of Returns and thereby reducing the number of risky transactions entering the ACH Network.

ODFIs: Some ODFIs, particularly those with high-risk Originators and Third-Party Senders with return rates near or exceeding the proposed return rate thresholds, are likely to incur additional costs associated with the development and implementation of better policies and procedures to ensure compliance with the return rate thresholds. Some ODFIs may need to modify origination activity to comply with these thresholds. Finally some ODFIs may incur costs associated with information requests from NACHA and rules enforcement actions by NACHA.

Originators and Third Party Senders: Originators and Third-Party Senders with excessive return rates will be compelled by their ODFIs, and, in the case of Originators, Third-Party Senders, to take action to reduce the excessive return rates and will incur costs in doing so.

RDFIs: RDFIs will benefit from a reduction in the number of Returns experienced, with an attendant reduction in the cost of processing such Returns, in the number of customer complaints that must be addressed, and in the reputational harm caused by improper access to the RDFIs' deposit accounts.

<u>Reinitiation Rules</u>

All Participants: NACHA expects all ACH Network participants to benefit from the reduction of the return rates associated with reinitiated Entries. These changes are expected to provide clarity to ODFIs with respect to the existing limitations and qualifications on reinitiations, thereby reducing the number of Returns and thereby reducing the number of returned reinitiated Entries.

ODFIs: Although the proposed rules are consistent with NACHA's interpretation of the existing reinitiation Rule, some ODFIs, particularly those with practices that do not comply with the limitation on and requirements for reinitiating returned Entries, are likely to incur additional costs associated with the development and implementation of better policies and procedures to ensure compliance with the Rules. Some ODFIs may incur costs associated with information requests from NACHA and rules enforcement actions by NACHA. ODFIs will incur some cost in modifying systems to include the REDEPOSIT indicator in Reinitiated Entries.

Originators and Third Party Senders: Originators and Third-Party Senders whose practices do not comply with the limitations on and requirements for reinitiating returned Entries are likely to incur additional costs associated with the development and implementation of better policies and procedures to ensure compliance with the Rules.

RDFIs: RDFIs will benefit from a reduction in the number of improperly reinitiated Entries and from clarification of the means by which such Entries may be Returned.

<u>Third-Party Rules Changes</u>

All Participants: NACHA expects all ACH Network participants to benefit from improved oversight of Third-Party Senders and Originators, which is expected to result in higher quality origination.

ODFIs: NACHA does not expect that ODFIs that practice prudent oversight of their Originators and Third-Party Service Providers will incur additional costs to comply with the Rules changes, which are intended to make explicit obligations that are inherent in the current Rules. ODFIs with weaker oversight of Originators and Third-Party Service Providers may incur additional costs associated with developing policies and practices whereby they can obtain and provide to

NACHA documentation of Originator and Third-Party Service Provider audits upon request by NACHA.

Third-Party Senders: NACHA does not expect that Third-Party Senders that practice prudent oversight of their Originators and proper audit practices will incur additional costs to comply with the *Rules* changes, which are intended to make explicit obligations that are inherent in the current *Rules*. Third-Party Senders with weaker oversight over Originators and/or that do not comply with the current audit requirements in the *Rules* may incur additional costs associated with developing policies and practices whereby they can monitor, assess and enforce limitations on their customers' origination and return activities and/or to conduct, and provide proof of, annual audits in compliance with the *Rules*.

Part V: Technical Summary

The proposed Rule would make the following changes to language within the *Rules:*

<u>*Return Rate Thresholds*</u>

- *Article Two, Subsection 2.17.2 (ODFI Return Rate Reporting)* – expands the ODFI's existing obligation to calculate return rates for unauthorized entries to include additional calculations of return rates for entries returned due to account data quality issues, and for all return entries excluding RCK.
- *Article Two, Subsection 2.17.2.1 (Additional ODFI Action and Reporting When the Return Rate Threshold is Exceeded)* – revises an ODFI's required action steps when one or more return rate thresholds is exceeded to (1) incorporate more generalized references to applicable Return Rate Thresholds defined elsewhere within the *Rules*, and (2) when applicable, require an ODFI to provide proof of completion of its Third-Party Senders' audits as part of the data provided to NACHA.
- *Article Two, Subsection 2.17.2.2 (ODFI Reduction of Return Rate)* – revises this subsection to incorporate a more generalized reference to applicable Return Rate Thresholds defined elsewhere within the *Rules*.
- *Article Eight, Subsection 8.89 (Return Rate Threshold)* – incorporates a new term "Return Rate Threshold" within the terms defined under the *NACHA Operating Rules*.
- *Appendix Ten (Rules Enforcement)* – revises the following sections within Appendix Ten to incorporate more generalized references to enforcement actions initiated with respect to violations of applicable Return Rate Thresholds defined elsewhere within the *NACHA Operating Rules*:
    - Part 10.1 (Scope)
    - Subpart 10.2.1 (National Association Request for Information)
    - Subpart 10.2.2 (National Association Action on Receipt of Information Reported by ODFI)
    - Subpart 10.4.1 (Initiation of a Rules Enforcement Proceeding)
    - Subpart 10.4.3 (Submission Requirements for Rules Enforcement Proceedings Initiated by the National Association)
    - Subpart 10.4.4.2 (Notice of Possible Fine)
    - Subpart 10.4.7.4 (Class 2 Rules Violation)

Reinitiation of Returned Entries

- *Article Two, Subsection 2.12.4.1 (General Rule for Reinitiated Entries)* – renames and expands existing Subsection 2.12.4 (Reinitiation of Returned Entries) to establish a new General Rule for reinitiated entries.
- *Article Two, Subsection 2.12.4.2 (Formatting Requirements for Reinitiated Entries)* – establishes a new subsection containing specific formatting criteria for entries to be reinitiated by an Originator/ODFI.
- *Article Two, Subsection 2.12.4.3 (Improper Reinitiation Practices)* – establishes a new subsection identifying reinitiation practices explicitly prohibited under the *NACHA Operating Rules*.
- *Article Eight, Section 8.78 ("Reinitiated Entry" or "Reinitiation" or "Reinitiate")* – incorporates Reinitiated Entries as a defined term under the *NACHA Operating Rules*.
- *Appendix One, Part 1.2 (Data Specifications for ACH Records)* – incorporates the term "REDEPOSIT" into the list of Company Entry Descriptions that must be capitalized by the Originator/ODFI.
- *Appendix Three, Subpart 3.2.2 (Glossary of Data Elements)* – requires the Company Entry Description field for Reinitiated Entries to contain the word "REDEPOSIT."

Third-Party Sender Topics

- *Article Two, Subsection 2.15.3 (Performance and Warranty of ODFI Obligations by Third-Party Senders)* – expands this subsection to explicitly state a Third-Party Sender's obligation to perform the risk monitoring obligations required of an ODFI.
- *Appendix Eight, Part 8.1 (General Audit Requirements)* – revises this section to state explicitly that (1) a Third-Party Sender/Third-Party Service Provider is obligated to provide proof of completion of its rules compliance audit to its ODFI, and (2) an ODFI's obligation to provide such documentation to NACHA upon request.
- *Appendix Ten, Subpart 10.4.7.4 (Class 2 Rules Violation)* – incorporates as a Class 2 rules violation the failure of an ODFI to provide proof of completion of its Third-Party's rules compliance audit.

NACHA Enforcement Authority

- *Appendix Ten, Subpart 10.4.1 (Initiation of a Rules Enforcement Proceeding)* – expands this subsection to permit the National Association to initiate a rules enforcement proceeding based on a reasonable belief that an ODFI, Third-Party Sender, or Originator has initiated entries without proper authorization in accordance with the *NACHA Operating Rules*.
- *Appendix Ten, Subpart 10.4.3 (Submission Requirements for Rules Enforcement Proceedings Initiated by the National Association)* – incorporates NACHA's belief that a violation of authorization requirements has occurred as a reason for the initiation of a rules enforcement proceeding.

Request for Information

Part VI: Request for Information on “Incomplete” Payroll Transactions

Recently a new set of provisions addressing Incomplete Transactions was added to the *Rules*.[10] An Incomplete Transaction is a payment to an intended payee that is funded by an ACH debit to a Consumer Account, but for which the corresponding payment to the intended payee is not completed by the Originator, Third-Party Sender or ODFI of that debit Entry.

The Incomplete Transaction Rule permits a consumer Receiver to request, and requires the RDFI to provide, a recredit for an Incomplete Transaction to the Receiver’s account, and provides for the return of the debit Entry under the same framework set forth in the *Rules* for recredit and return of an unauthorized debit Entry. Currently, the Incomplete Transaction Rule applies only to debits to Consumer Accounts that are used as funding sources, and not to similar debits to non-Consumer Accounts. Non-Consumer Accounts that are used as funding sources remain subject to the requirement that a returned Entry be made available to the ODFI no later than the opening of business on the second Banking Day following the Settlement Date of the debit Entry. There presently is no practical way for a business Receiver of a debit Entry to initiate a return if a Third-Party Sender fails to complete the transfer that was intended to be funded with that debit.

NACHA previously requested feedback on whether the Incomplete Transactions provisions, including the extended return time frame, should also apply to debit Entries to business Receiver accounts, but the industry did not support extension of the new Incomplete Transaction provisions to non-Consumer Accounts. A scenario has come to light, however, that warrants reconsideration of whether the Incomplete Transaction Rule should be expanded to cover at least a limited pool of debits to non-Consumer Accounts or whether the *Rules* should be modified in another way to address this situation.

Specifically, there have been situations in which a debit Entry is initiated by a Third-Party Sender that is a payroll services provider in order to fund a business’ payroll, but the Third-Party Sender goes bankrupt or otherwise ceases operations before completing the corresponding payroll credits to employees.[11] Because the employer (Receiver of the funding debit Entry) does not learn about the failure of the payroll provider to make payments to the Receiver’s employees until after the return timeframe has passed, there is no basis for the RDFI to return the debit Entry. Nor can a warranty claim be made on the basis that the debit Entry was unauthorized. In the payroll context, the employer explicitly authorizes the payroll service provider to debit the employer’s account. A subsequent failure of the payroll service provider to fulfill some other contractual obligation(s) generally would not affect the validity of the underlying debit authorization.

In this limited circumstance, although the debit Entry is to a non-Consumer Account, the ultimate beneficiary of the related credit is a consumer who is dependent upon the completion of

[10] See Section 3.12.3 Incomplete Transaction.
[11] The payroll payments to the employees might not be ACH credits. The funding debit to the employer’s account might be an ACH debit, while the payments to employees might be by check.

payroll payment. Moreover, many users of such services are small businesses who may have challenges adequately assessing the financial condition of their service providers. Recent failures of payroll service providers, though few a number, have had a negative impact on the reputation of the ACH Network since the ODFIs that enable these service providers to access the ACH Network may not stand behind the provider in the event that the provider fails.

Because of the unique attributes of payroll processing, NACHA is requesting information as to whether there is interest in modifying the *Rules* to provide some rights for employers and their RDFIs in this scenario. One option would be to narrowly expand the existing Incomplete Transaction Rule to cover only payroll processing. Such an expansion could:

- Narrowly tailor an extended return right solely for Incomplete Transactions for payroll funding debits where the employees' payroll payments to employees are not made; and/or

- Require the ODFIs of the Third-Party Sender to honor late returns of funding debits when payroll payments are not made.

While this would place new obligations on ODFIs, presumably ODFIs would manage this risk by more closely overseeing their payroll processing clients, including, for example, by requiring that payroll processing funds be held in segregated accounts to help isolate the funds from the processor's corporate assets. Because this would be a significant change in ODFI obligations, however, NACHA is first seeking preliminary reactions to assess whether any change to the *Rules* to address the situation would be beneficial to the industry.