



Automatic Clearinghouse Transactions: (Almost) Everything You Ever Wanted to Know

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What's the Big Deal with ACH?

- ▶ Two key reasons it's a big deal: Volume and Value and there's a lot of each.
- ▶ FY 2019 Statistics:
- ▶ Volume 24.7 Billion individual transactions (75 transactions per person in the US - 14.4 billion debits 10.3 billion credit)
- ▶ Value 55.8 Trillion Dollars-(19.6 Trillion Debits 36.2 Billion Credits)
- ▶ From FY 2018 that's a 7.7% increase in volume and an 8.9% increase in value.

Volume and Value – FY 2019 (con't)

- ▶ Transaction Types to watch - These transactions are increasing:
- ▶ P2P (Peer to Peer) - up 18.9% to \$153MM
- ▶ Direct Deposit - up 6% to \$7.2B)
- ▶ B2B (Business to Business) - up 12% to 4B
- ▶ Internet Payments - up 13.3% to \$6.7B
- ▶ Healthcare Payment - up 11.9% to 343.2MM

- ▶ * As compared to FY 2018

Volume and Value – FY 2020 (so far)

- ▶ P2P - up 48.4% (\$53.3MM)
 - ▶ Healthcare - down 8.2% (\$79.6MM)
 - ▶ Direct Deposit - up 17% (\$2.1B)
 - ▶ B2B - up 3.6% (\$1B)
 - ▶ Internet 0 up 15.8% (\$1.9B)
- ▶ (Data is for 2Q 2020 alone compared against 2Q 2019)

ACH Overview

- ▶ As Payment Systems go, ACH can be a little mystifying.
- ▶ Generally not large dollar amounts for individual transactions like wire transfers.
- ▶ Not a significant developed body of case and statutory law going back 100 years like checks
- ▶ ACH Transactions are primarily governed by private operating rules rather than statutory or regulatory guidelines
- ▶ Benefit of this is that updates to private operating rules move so much faster than federal regulations or statutes
- ▶ ACH was developed in the 1970s, specifically intended as an alternative to paper checks
- ▶ NACHA – National Automatic Clearing House Association a non-profit trade association founded in 1974

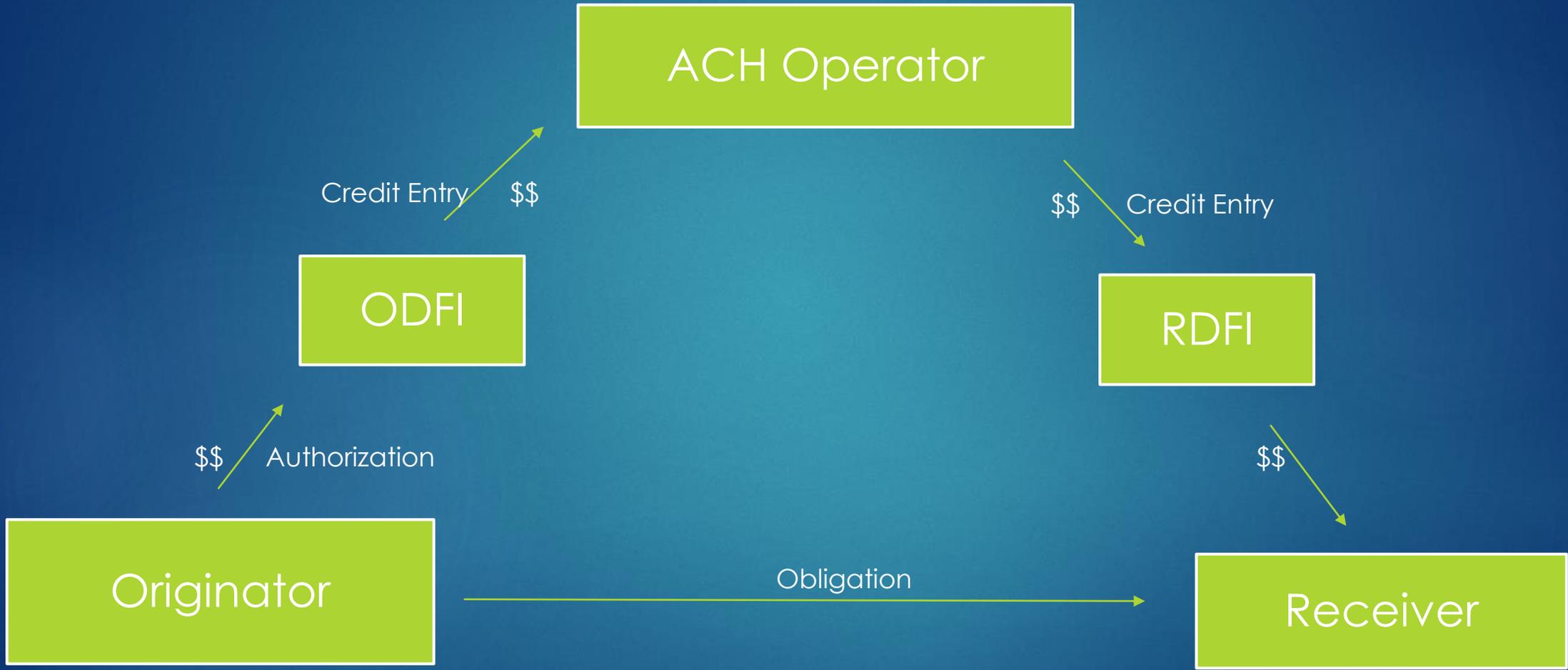
Sidebar: What are the NACHA Rules?

- ▶ According to NACHA itself: “The Nacha Operating Rules are the foundation for every ACH payment. By defining the roles and responsibilities of financial institutions and establishing clear guidelines for each Network participant, the Rules ensure that millions of payments occur smoothly and easily each day.”
- ▶ The intent is to keep ACH transactions safe and efficient.
- ▶ The NACHA Rules apply in one way or another to all the parties to an ACH Transaction, whether to provide technical operational procedures, or to provide warranties that allocate liability for losses.
- ▶ Not law or regulation in the strict sense. All parties to an ACH transaction agree to be bound by the NACHA Rules.

ACH Overview

- ▶ **Credit entry** is initiated by the payor (asking the payor's institution to credit the payee's account the amount of the payment).
- ▶ **Debit entry** initiated by the payee (asking payee's institution to debit the payee's account)
- ▶ **Originator** - Party that initiates the transaction. Credit - payor. Debit - payee.
- ▶ **Originating Depository Financial Institution (ODFI)**. Financial Institution of the originator. Credit – holder of the account from which the payment is to be made. Debit - holder account to which the payment is to be paid.
- ▶ **ACH Operator** - the Party that carries the communications and funds to facilitate the transaction. Typically, the relevant federal reserve bank or banks.
- ▶ **Receiving Depository Financial Institution (RDFI)** – Receiver's financial institution. account to which payment is to be made (credit). Account from which payment is to be made (debit)-
- ▶ **Receiver** - account to which the entry is directed. Credit (payee). Debit (payor).

ACH Credit Transaction Overview



ACH Debit Transaction Overview

ACH Operator

ODFI

RDFI

Originator

Receiver

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Debit Entry

Debit Entry

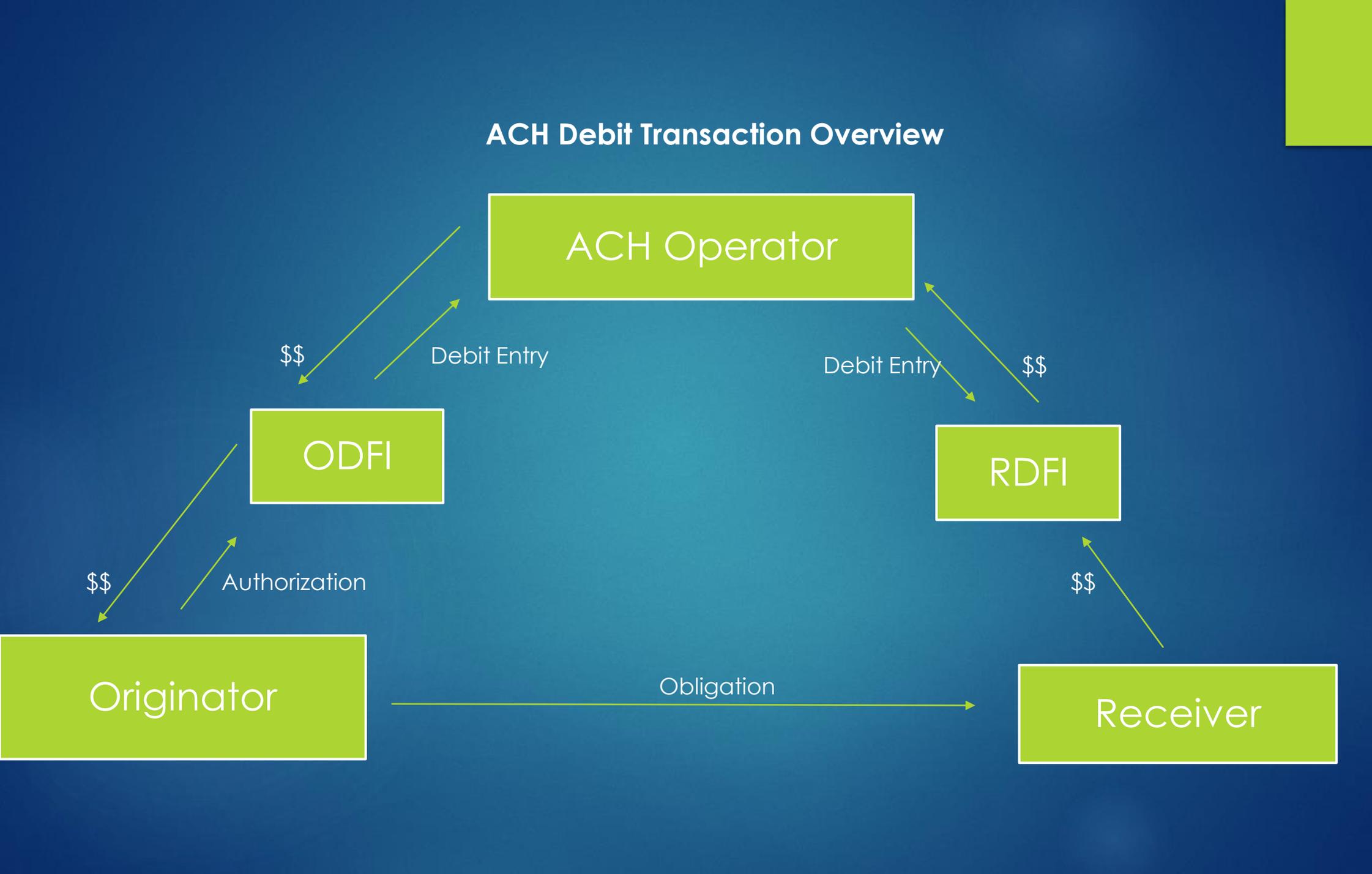
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Authorization

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Obligation



What law Governs ACH Transactions?

- ▶ A variety of governmental statutes, regulations and operating rules apply to ACH transactions.
- ▶ Contractual agreements may apply between the parties as well.
- ▶ All apply in various ways from a practical operational standpoint, as well as a loss allocation and a consumer protection perspective.
- ▶ What this means is that different components/steps of any ACH Transaction will be subject to different laws regulations or rules. The key to navigating ACH transaction is knowing where to look for the answer.
- ▶ Let's break down an ACH transaction into its key components.



Originator ← → Receiver

What controls the rights and remedies between the originator and the receiver? Whatever gives rise to the underlying obligation – the terms of whatever obligates one party to pay the other.

- If Mortgage Payment – a promissory note or credit agreement
- If Direct Deposit – Wage an Hour laws or an Employment Contract
- If a B2B payment - Purchase Order/Invoice
- Private Contract or other arrangement between the Parties
- As an RDFI or ODFI, this won't be of as much concern to you



Originator ↔ ODFI

- **EFTA and Reg E** – Reg E applies to consumer ACH transaction based on the broad definition of “electronic funds transfer” in 15 U.S.C. Section 1693a(7) and 12 C.F.R. § 1005.3. Reg E applies to the transaction as it relates to, for example, consumer liability for unauthorized transactions, and assessment of overdraft fees arising out of ACH transactions.
- **NACHA Rules** – As between the Originator and the ODFI, the NACHA Rules provide, among other things - guidance for when an entry is authorized by the Originator, when stop payment orders are effective, what diligence an ODFI must perform on an Originator
- **Deposit Account Agreement** – to the extent the above may be modified by agreement an ODFI can do so in the Deposit Account Agreement.



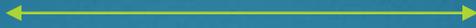
Receiver ↔ RDFI

- **EFTA and Reg E** - Reg E applies to the transaction as it relates to, for example, consumer liability for unauthorized transactions, and assessment of overdraft fees arising out of ACH transactions.
- **NACHA Rules** – Dictate and provide guidance on, for example, what notice of entries must be provided by an RDFI to a Receiver, RDFI's obligations to stop payment
- **Regulation CC** – If the transaction is a credit transaction, Reg CC provides guidance for when the funds must be made available to the receiver.
- **Deposit Account Agreement** – If Reg E and the NACHA Rules can be varied (relevant question for consumer transactions) this is where to do it.



- Federal Reserve Operating Circular No. 4
- Private Clearinghouse Rules
- Regulation J
- The above detail what warranties are made to the Federal Reserve Bank or to the Clearinghouse and what indemnity obligations exist.

ODFI



RDFI

- **NACHA Operating Rules** – creates obligations as to DFI risk assessments, determines when the RDFI must accept entries, when credits must be made available, the RDFI's right to return entries, and systemic procedures for how the transactions are accomplished.
- Key provisions are the warranty and indemnity obligations between the **participating DFIs**
- Specific Case law holding that NACHA indemnity obligations do **not** run from the Receiver to the Originator – The obligations strictly apply bank to bank. This is unlike the UCC warranties for checks.
- NACHA allocates the risks between the ODFI and the RDFI

Types of Transactions

- ▶ IAT – International ACH transaction
- ▶ P2P – Originated by a consumer intended to a consumer
- ▶ POS – Point of Sale entry
- ▶ WEB – Internet initiated/Mobile Entry
- ▶ TEL – Telephone entry – authorized orally via telephone
- ▶ RCK – Entries that are checks re-presented as ACH payments
- ▶ The Transaction Type communicates distills the nature of the transaction and communicates to both the RDFI and the ODFI how much risk is involved with an individual ACH Transaction

Speaking of Risks

- ▶ Good news: individual ACH transactions are generally in small amounts (esp. as compared to other payment systems) which means the risk in individual transactions is low
- ▶ Given that your significant risk is at a volume basis rather than transaction level, you want to have solid policies and procedures in place to manage and minimize your risk in connection with ACH transactions.
- ▶ Like all payment systems, ACH has its own specific considerations relative to Data Security and Vendor Management.
- ▶ A lot of the risk is similar to checks, since ACH is intended to make checks unnecessary.
- ▶ Interplay between final settlement between FIs and funds availability to customer (insufficient fund risk)
- ▶ Significantly more fraud risk in light of electronic nature of the transactions – e.g. WEB and TEL

How is Risk Allocated

- ▶ NACHA generally allocates the risk between the ODFI and the RDFI as follows:
- ▶ The ODFI, as the party in the best position to verify the validity of the transaction, makes several warranties to the RDFI in connection with entries, including (1) that the entry is properly authorized, (2) the entry is in an amount which on the settlement date will be due and owing by the originator to the receiver and (3) contains the correct account and routing number of the receiver. The indemnities only apply if the RDFI has complied **with the terms of the entry**.
- ▶ Subject to these warranties, the NACHA rules impose a return deadline on the RDFI beyond which the entry can no longer be returned by the RDFI.

How to mitigate ACH Risk

- ▶ Perform diligence on Originators – and avoid risky customers.
- ▶ Use pre-funding arrangements or reserves. Have limits in place as a matter of policy.
- ▶ Because of the timing of funds available vs. final settlement, both the RDFI and ODFI take on credit risk. Treat commercial ACH customers like unsecured borrowers.
- ▶ How Third Party Senders complicate ACH Transactions and increase risk.



Or worse yet



- What is a Third Party Service Provider – classic and legitimate example is a payroll company.
- How can the ODFI Complete diligence on the Originator and the Transaction when the connection is that attenuated?
- NACHA modified the rules to provide that Third Party Senders to the ODFIs that (1) the entry is authorized, (2) that the Third Party sender is legally able to perform the “outsourced” obligations of the ODFI, and indemnifies the ODFI for losses for violating the indemnity.

Third Party Sender Risk

- An indemnity is only as good as the solvency and viability of the party providing it.
- Have a solid agreement with a Third Party Service provider in place. They should have insurance. They should warrant they will comply with NACHA as though they are the ODFI. Have them provide reps and warranties as to their direct relationship with the Originator.
- ▶ Perform diligence on them like they are an unsecured borrower. Imagine if the third party sender files bankruptcy in the middle of a significant ACH transaction.

Same Day ACH

- ▶ Virtually all types of ACH payments, including both credits and debits, are eligible for same-day processing.
- ▶ Only international transactions (IATs) and high-value transactions above \$25,000 are not eligible.
- ▶ Eligible transactions account for approximately 99 percent of current ACH Network volume.
- ▶ All RDFIs are required to receive same-day ACH payments, thereby giving ODFIs and Originators the certainty of being able to send same-day ACH payments to accounts at all RDFIs.
- ▶ Same-day payrolls, supporting business' needs to pay hourly workers, and providing flexibility for late and emergency payrolls and missed deadlines; and enabling employees to have faster access to their pay in these cases

Same Day ACH

- ▶ Business to-Business payments, enabling faster settlement of invoice payments between trading partners, and including remittance information with the payments.
- ▶ Expedited bill payments using both ACH credits and debits, enabling consumers to make on-time bill payments on due dates, and providing faster crediting for late payments;
- ▶ Account-to-account transfers, providing faster crediting for consumers who move money among various accounts they own.
- ▶ This new rule expands access to Same Day ACH by allowing Same Day ACH transactions to be submitted to the ACH Network for an additional two hours every business day. The new Same Day ACH processing window will go into effect on March 19, 2021.

What's on Tap

- ▶ One of the benefits of a Payment System that's dictated primarily by Private Operating Rules is that NACHA is in a position to expeditiously make changes to processes that aren't working.
- ▶ Look at the changes for Same Day Processing. NACHA noticed a deficiency and moved quickly to address it.
- ▶ Let's take a few minutes to talk about current outstanding proposals that NACHA has outstanding.

Modernization Changes

- ▶ Explicitly define and better enable the use of standing authorizations for consumer ACH debits, thereby better accommodating the use of new technologies and business methods that make use of frequent or occasional interactions between parties to transact;
- ▶ Define and allow for the use of oral authorization of consumer ACH debits beyond telephone calls, thereby better accommodating the use of new technologies and business methods that make use of verbal interactions and voice technologies;
- ▶ Clarify and provide greater consistency of authorization standards for consumer ACH debits across payment authorization and initiation channels;
- ▶ Reduce the administrative burden of providing proof of authorization of a consumer ACH debit; and,
- ▶ Reduce the administrative burden associated with the Written Statement of Unauthorized Debit by better facilitating the use of electronically and orally provided statements.
- ▶ Creates a Standing Authorization with respect to subsequent entries by a consumer. Would go into effect July 1, 2021.

Significant Fraud Prevention Proposal

- ▶
- ▶ Would go into effect March 8, 2022.
- ▶ These proposed changes would provide ACH Network participants with more reliable, low-cost, ACH Network-based solutions to validate a Receiver's account. Fraud Prevention. Upgrade to the ACH Network's account validation capabilities, which many users currently consider slow and inconclusive.

1. Changes to Prenotification Process

- ▶ Increase the effectiveness of Prenotification process. A prenotification test is a \$0 test transaction that an originator can use prior to originating live entries.
- ▶ Right now, RDFI responds to a prenotification with a Return or a Notification of Change only when the account info is not valid - no response when it's valid.
- ▶ New Rule - RDFI would respond Y or N to all prenotes. This accelerates the notification and response process systemically. Prenotes would then be processed by the ACH operators during the next available processing window, including the three same day processing windows.
- ▶ RDFI would respond to prenotes no later than the processing window on the next Banking Day that corresponds to the processing window in which the prenote was received - usually about 24 hours.
- ▶ Originators would be able to send live entries as soon as they get the Yes response. substantially shorter waiting period than the current 3 day waiting period.
- ▶ Also would establish standardized formatting requirements for prenotes - systemic improvement.
- ▶ Prenotes will have the word VALIDATION in the Company Entry Description Field, Company name field must contain the name by which the Originator is known to and readily recognized by the receiver, and the prenote must bear the appropriate transaction code.

2. Changes to Micro-Entry Process

- ▶ Proposal would create formal rules for Micro-Entries for account validation. \$1 charges. This was created organically by the industry.
- ▶ Rule would provide clarity and formatting standards to formalize the process. This would enable RDFIs to send alerts to consumers about these requests which would improve their effectiveness.

3. Changes to Notification of Change Process

- ▶ Originator would be prohibited from invalidating a Receiver's authorization due to the receipt of a NOC. This is often leads to repeat and ongoing NOCs.
- ▶ Would increase enforcement for not using the corrected information provided for in the NOC. ODFI's failure to comply with the NOC by using the corrected information would result in rules violations and potential fines by the ACH operator.
- ▶ Goal is to increase speed, but maintain fraud and error mitigation practices. Often more appropriately accomplished systemically rather than legally or by regulation. Also fewer exceptions for live ACH entries, also fewer situations that revert to check due to account number problems.

Fraud Detection for WEB Debits

- ▶ Would go into effect March 19, 2021.
- ▶ Currently, ACH Originators of WEB debit entries are required to use a “commercially reasonable fraudulent transaction detection system” to screen WEB debits for fraud. This existing screening requirement will be supplemented to make it explicit that “account validation” is part of a “commercially reasonable fraudulent transaction detection system.”
- ▶ The supplemental requirement applies to the first use of an account number, or changes to the account number.

Fraud Detection for WEB Debits

- ▶ As an ODFI you may have to re-tool your fraud detection for WEB transactions - your cost may go up.
- ▶ As an RDFI you may see an increase in ACH prenotifications, micro-transactions, or other account validation requests. Only applies on a going-forward basis.
- ▶ Doesn't explicitly require that you verify the identity of the account holder, just that an account is open and accepts ACH entries.
- ▶ However, because the determination of whether a business practice is considered commercially reasonable depends on a particular ODFI's business model and risk profile, and how it compares to similarly situated ODFIs, each ODFI will need to determine for itself, whether verifying simply that an account is open is sufficient. For some Originators, a more rigorous assessment that also verifies account ownership may be appropriate to meet a commercially reasonable standard.
- ▶ Originators are in the best position to detect and prevent fraud related to payments they are initiating, but in recent risk events perpetrated via social media channels, it has become apparent that some ACH Originators do not have or use any such system to screen WEB debits.

Improper Reversals

- ▶ Would be effective January 1, 2021.
- ▶ Would further specifically state that the initiation of Reversing Entries or Files for any reason other than those explicitly permissible under the Rules is prohibited.
- ▶ It would also explicitly define within the Rules non-exclusive examples of circumstances in which the origination of reversals is improper:
 - ▶ The initiation of Reversing Entries or Files because an Originator or Third-Party Sender failed to provide funding for the original Entry or File
 - ▶ The initiation of a Reversing Entry or File beyond the time period permitted by the Rules

Improper Reversals

- ▶ This proposal would provide Nacha with the authority to take enforcement action with respect to an “Egregious Violation” of the Operating Rules.
- ▶ It would define an Egregious Violation as a willful or reckless action that impacts at least 100 Participating DFIs, or affects Entries in the aggregate amount of at least \$1 Million.
- ▶ The proposed change would also allow the ACH Rules Enforcement Panel to classify Egregious Violations as a Class 2 or 3 Rules Violation. (The maximum sanction for a Class 3 violation is \$500,000 per occurrence and a directive to the ODFI to suspend the Originator or Third-Party Sender).
- ▶ In addition, it would expressly authorize Nacha to report Class 3 Rules violations to the ACH Operators and industry regulators.

What to do to Stay Up to Date

- ▶ Take advantage of what NACHA offers
- ▶ Be sure all your internal stakeholders from a variety of internal departments are involved - everyone will take something different based on their role in the organization. Risk will look at something and reach a different conclusion than ops - each perspective is correct and each perspective is vital to your organization.



Thank you for your time and attention.

Any Questions?