

SOUTHERN MICHIGAN BANK & TRUST

ACH Origination Quick Reference Guide

This is a Quick Reference Guide only and is meant to assist you with some of the most common ACH questions. This document is only a guide. It does not replace the Nacha Operating Rules and does not contain all rules or regulations that govern the use of the ACH network. In the event of any inconsistency between this document and the Nacha Operating Rules, the Nacha Operating Rules shall prevail.

ACH Overview

Overview of the System

The ACH Network is an Agreement based batch and forward processing system. Instead of sending payments individually, financial institutions process ACH entries at predetermined times throughout the processing day.

Debits or Credits

ACH Credits occur when an Originator initiates a transfer to move funds to a Receiver's account. **ACH Debits** flow the opposite way and funds are collected from the Receiver's account and credited to the Originator's.

Consumer or Corporate

ACH entries are categorized as "consumer" or "corporate" depending on the relationship of the parties to the transaction and the type of Receiver account. The rules governing ACH entries vary depending on the type of transactions being originated.

Consumer Transaction Examples (not all inclusive)

- Insurance Premiums
- Mortgage and/or loan payments
- Payroll
- Dividends

Corporate Transaction Examples (not all inclusive)

- Cash concentration and disbursement
- Vendor payments (B2B)
- Corporate trade payments
- State and Federal tax payments

Standard Entry Class (SEC) Codes

Each ACH transaction is assigned a **Standard Entry Class** or **SEC Code**, which indicates the type of entry being sent and determines the rules that apply. Please refer to your ACH Cash Management agreement to determine which SEC codes you are authorized to process.

Participants and Definitions

Originator: entity or individual that initiates ACH entries to the payment system according to an arrangement or agreement with a Receiver.

Receiver: entity or individual who has authorized an Originator to initiate an ACH entry in to their (the Receiver's) account.

Originating Depository Financial Institution (ODFI): the institution that accepts ACH payment instructions from an Originator and allows ACH entries to the payment system.

Receiving Depository Financial Institution (RDFI): the institution that receives ACH entries and posts them to the accounts of its depositors (the Receivers).

Automated Clearing House Operator (ACH Operator): an entity that acts as a central facility for the clearing, delivery, and settlement of Entries between or among Participating DFIs.

Third-Party Service Provider: an Organization that performs any functions, such as creating Files or processing Entries, on behalf of an Originator, Third-Party Sender, ODFI, or RDFI. Third-Party Service Provider may also act as a Sending Point or Receiving Point on behalf of a Participating DFI.

Third-Party Sender: a type of Third-Party Service Provider that acts as an intermediary in Transmitting Entries between an Originator and ODFI, including through Direct Access, and on behalf of an Originator or another Third-Party Sender. A Third-Party Sender must have an Origination Agreement with the ODFI. A Third-Party Sender is never the Originator for Entries it Transmits on behalf of another Organization. However, a Third-Party Sender of Entries may also be an Originator of other Entries in its own right. You have an obligation to disclose your role as a Third-Party Sender.

Nested Third-Party Sender: a Third-Party Sender that has an agreement with another Third-Party Sender to act on behalf of an Originator, and does not have a direct agreement with the ODFI. You have an obligation to disclose any nested third-party relationships.

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ACH Data Security Requirements

The ACH Data Security Framework requires non-consumer participants to create a framework and complete a self-assessment to protect the security, confidentiality, and integrity of ACH data through the payment life cycle. All Originators must comply with the ACH Data Security Framework Rule.

Article One, Section 1.6 Security Requirements

Establish, implement and update, as appropriate, policies, procedures, and systems with respect to the initiation, processing, and storage of entries that are designed to:

- a. protect the confidentiality and integrity of Protected Information until its destruction;
- b. protect against anticipated threats or hazards to the security or integrity of Protected information until its destruction; and
- c. protect against unauthorized use of protected information that could result in substantial harm to a natural person.

Such policies, procedures, and systems must include controls that comply with applicable regulatory guidelines on access to all systems used by such non-consumer Originators, Participating DFI or Third-Party Service Provider to initiate, process and store ACH entries.

Article Eight, Section 8.80 Protected Information

The non-public personal information (including financial information) of a natural person used to create or contained within, an entry and any related addenda record.

Chapter 4 General Rules – ACH Data Security Requirements

Protection of Sensitive Data and Access Controls Originators must establish, implement and update security policies, procedures and systems related to the initiation, processing and storage of entries and resulting Protected Information.

Protection of Account Numbers used in ACH Processing Large, non-FI originators must protect deposit account information used in the initiation of ACH transactions by rendering it unreadable when stored electronically.

Self-Assessment Originator must verify that it has established, implemented, and updated data security policies, procedures and systems as required by the Rules.

Legal Framework

All ACH originators are bound by various rules, regulations and agreements. The list below includes some of the rules, regulations and agreements with which ACH originators must comply.

- Nacha Operating Rules (www.nacha.org or www.achrulesonline.org)
- Applicable US laws, including OFAC-enforced sanctions
- The Electronic Funds Transfer Act as implemented by Regulation E (for consumer entries)
- Uniform Commercial Code Article 4A (for corporate credits)
- ACH origination agreements between Originator (you) and ODFI (SMBT)
- Deposit account agreements between Originator (you) and ODFI (SMBT)
- Agreements between the originator (you) and vendors, customers and/or employees

The ODFI (SMBT) binds the Originator (you) to the Nacha Operating Rules through the ACH origination agreement. The ODFI (SMBT) has the right to audit the Originator's (your) compliance with the origination agreement and the Rules and can suspend or terminate services for breach of the Rules.

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ACH Authorization Requirements

The type of authorization between the Originator and Receiver depends on the type of entry being initiated. An authorization must comply with applicable Legal Requirements, be readily identifiable as an authorization, and have clear and readily understandable terms.

Consumer Receivers For credit entries to a consumer Receiver's account, the Originator must obtain authorization from the Receiver, but may obtain this authorization in any manner permitted by applicable Legal Requirements.

For debit entries to a consumer Receiver's account, the Originator must obtain a written authorization that is signed or similarly authenticated and must include:

1. Language indicating whether the authorization by the Receiver is for a Single Entry (one time), multiple Entries, or Recurring Entries;
2. The amount of the Entry(ies) or an explanation of how the amount of the Entry(ies) will be determined;
3. The timing (including start date), number, and/or frequency of the Entries (if Receiver is authorizing multiple or Recurring Entries);
4. The Receiver's name;
5. Details of the account to be debited (routing and account numbers, type of account, etc.);
6. The date of the Receiver's authorization; and
7. Language that instructs the Receiver on how they may revoke their authorization with the originator. This must include the time and manner in which the Receiver's communication to the Originator must occur.

Corporate Receivers The Originator of any Entry to a non-Consumer Account may obtain the Receiver's authorization in any manner permitted by applicable Legal Requirements and must obtain the Receiver's agreement to be bound by these Rules.

Retention The Originator must retain the original or a copy of each written authorization of a Receiver for two years from the termination or revocation of the authorization. Upon the ODFI's request, the Originator must provide a copy of the authorization.

Refer to **Section 2.3 Authorization and Notice of Entries** of the Nacha Operating Rules for additional information on authorization requirements.

Recommended Fraud Prevention Measures

Computer Security

- Layered security – use encryption and anti-virus software to protect devices and networks
- Online banking security – do not continue online banking activity if the application looks different from usual. Immediately contact the bank.
- Social engineering education – educate employees about the prevalence of cyber-crime and business email compromise.
- Out of band or multi-factor authentication – strengthen the security of your credentials by enabling additional security protocols.
- User Accounts – require all employees to use strong passwords and update their passwords on a regular basis, prohibit sharing login credentials

Awareness

- Business Email Compromise occurs when legitimate business email accounts are either compromised or impersonated, and then used to order or request the transfer of funds.
- Vendor Impersonation Fraud happens when fraudsters impersonate a legitimate vendor or contractor and contact businesses or public-sector entities requesting to change payment account information.

Sound Business Practices

- Authenticate requests for payment or to change payment information using known contact information.
- Implement dual control and require two people to approve payments or make changes to payment information
- Routine reconciliation – review account activity daily and report any suspicious activity immediately.
- Account services – take advantage of fraud mitigation services like positive pay that are offered by your financial institution.
- Understand that these types of attacks can also be made by phone, fax, or letter in the mail.

This list is not a full list of risks, mitigation techniques, or mandatory instructions. Each organization must evaluate its risks and design appropriate security measures to mitigate those identified.

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ACH Corrections

A **Notification of Change** or **NOC** is a non-dollar ACH entry initiated by an RDFI to correct information contained in a received ACH entry.
The Originator of the entry must update the information within 6 business days, or prior to the initiation of the next transaction, whichever is longer.

ACH Returns

ACH entries can be returned for a variety of reasons including insufficient funds (NSF), account closed, incorrect account number, etc.
Depending on the reason for the return, the Originator may be required to obtain a new ACH authorization prior to initiating additional entries.

Common NOC Reason Codes

Code	Description	Timeframe
C01	Incorrect Account Number	All NOC entries should be initiated by the RDFI within two banking days of receiving the entry that contained incorrect information
C02	Incorrect Routing Number	
C03	Incorrect Routing and Account Numbers	
C05	Incorrect Transaction Code	
C06	Incorrect Account Number and Transaction Code	
C07	Incorrect Routing and Account Numbers and Transaction Code	

You will be notified of the details of any returns or corrections received for your originated entries. If you have any questions, our teams will assist you.

PLEASE NOTE: The reason codes listed on this page are not all encompassing. You may receive a return or NOC with a code or reason that is not listed on this page. If this occurs, SMBT teams will assist you and provide further information on how to resolve the entry.

The Nacha Operating Rules require ODFIs to monitor return activity and set certain return ratio thresholds for ACH Originators. If your return activity exceeds these requirements, SMBT may contact you to discuss your origination and return activity. Unsatisfactory resolution to elevated return ratios may lead to the suspension of ACH origination services.

Common Return Reason Codes

Code	Description	Time Frame	Can Entry be Reinitiated?
R01	Insufficient Funds/NSF	2 Banking Days	Yes, twice within 180 days of original entry. Enter RETRY PYMT in Company Entry Description field.
R02	Account Closed	2 Banking Days	With new authorization
R03	No Account/Unable to Locate Account	2 Banking Days	Yes, if information is corrected and within 180 days of original entry
R04	Invalid Account Number Structure	2 Banking Days	
R05	Unauthorized Debit to Consumer Using Corporate SEC Code	60 Calendar Days	Only with new authorization
R07	Authorization Revoked	60 Calendar Days	Only with new authorization
R08	Payment Stopped	2 Banking Days	Yes, if authorized by the Receiver
R10	Originator unknown to or not authorized to debit Receiver's account	60 Calendar Days	Only with new authorization
R11	Not in accordance with authorization, incomplete	60 Calendar Days	Yes, if authorized by the Receiver
R15	Beneficiary or Account Holder Deceased	2 Banking Days	No
R16	Account Frozen/returned per OFAC Instruction	2 Banking Days	No
R20	Non-Transaction Account	2 Banking Days	No
R29	Corporate Customer Advises Not Authorized	2 Banking Days	Only with new authorization

Reversals

What is a reversal? A best effort to collect for a duplicate or erroneous entry. A reversal can be initiated if the entry falls in to one of the following categories:

1. Duplicate of a previously initiated entry
2. Resulted in a credit or debit to the wrong Receiver
3. Incorrect amount initiated

The initiation of Reversing Entries or Files for any reason other than those explicitly permissible under the Rules is prohibited. Contact SMBT for assistance if you need to initiate a reversal entry or file.

Reversal Requirements

- Must be initiated within 24 hours of discovery of the error and transmitted within 5 banking days of the original entry/file.
- Company Entry Description must read "REVERSAL". Failure to update may cause unauthorized returns.
- Company ID, SEC Code and Amount of the Reversing Entry must be identical to the original entry.
- Transaction must be changed to the opposite type (use a debit to reverse a credit). Failure to update this will result in duplicate entries.
- Reversing files must be initiated for the same dollar amount of the original file.
- If a reversal is initiated due to incorrect dollar amounts, the correcting entry or file should be initiated at the same time and with the same effective date.

Remember, the RDFI cannot refuse a reversing entry, but it can return one for an appropriate reason, such as NSF, account closed, etc. The RDFI is under no obligation to post a reversing debit if it will overdraw the Receiver's account or if the Receiver's account has been closed.

Prenotifications

What is a pre-note? A pre-note (or pre-notification) is a non-dollar ACH transaction that may be initiated by an Originator prior to a recurring debit or credit entry. The RDFI is only responsible for verifying the account number; verification of the account ownership is optional. The pre-note is intended to verify the accuracy of the account information before the transmission of a live entry.

The RDFI receiving the pre-note is required to verify the Receiver's account number. It may choose to verify additional information (such as the Receiver's name), but it is under no obligation to do so.

Timing

A "live" or monetary entry may be initiated as soon as three banking days following the initiation of a pre-note.

Process Flow

As with any other ACH entry, the Originator may receive a return or NOC for a pre-note entry. In the event that a pre-note is returned, or NOC received, the Originator should not initiate another transaction without first investigating the reason for the return or correcting the transaction as indicated in the NOC.

SMBT recommends its Originators send a pre-note for all new Receiver accounts.

If a pre-note is returned, the Originator is not permitted to initiate any additional Entries to the Receiver's account until it has corrected the reason for the return, or made the change requested through a Notification of Change (NOC). Please refer to the previous pages for additional information on how to process returns and notifications of change.

Company Entry Description

What is a company entry description? A data field within the ACH entry record which provides the receiver with additional information as to the purpose of the payment and help manage risk. The Rules require a standard entry description of **PAYROLL** be used for PPD credits initiated for the payment of wages, salaries and similar types of compensation.