



June 3, 2011

Jennifer J. Johnson  
Secretary

Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, D.C. 20551

Re: Proposed Amendment to Regulation CC Regarding Availability of Funds and  
Collection of Checks (Docket No. R-1409) – Comments on Check Fraud Liability

Dear Ms. Johnson:

In connection with the recently proposed rules (the “Proposed Rules”) to revise Federal Reserve Regulation CC (“Regulation CC”), The Clearing House Association L.L.C.<sup>1</sup> (“The Clearing House”) respectfully submits for consideration by the Board of Governors of the Federal Reserve System (the “Board”) the proposed amendment to Regulation CC set forth below to clarify the rules governing the liability of depository institutions for the financial loss that results from check fraud when a check is presented to the paying bank as a substitute check or an electronic collection item. This comment letter is supplemental to the joint comment letter to be submitted by The Clearing House together with the Electronic Check Clearing House Organization, the Independent Community Bankers Association, and BITS to the Board regarding other provisions of the Proposed Rules. The Clearing House also respectfully requests that the Board reconsider the separate comment letter filed by The Clearing House on October 28, 2010 regarding treatment of paperless remotely created checks under Regulation CC (the “October TCH Comment Letter”), as more fully described in Part IV of this letter.

Today, most banks truncate physical checks and retain only digitized images of the originals, if they receive original checks at all. According to the 2010 Federal Reserve Payments Study, in 2009, 13 percent of checks were originally deposited as images and 96 percent of all checks cleared through the Federal Reserve for forward collection were cleared electronically. Processing and storing check images is faster and less expensive than processing and storing

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<sup>1</sup> Established in 1853, The Clearing House is the nation’s oldest banking association and payments company. It is owned by the world’s largest commercial banks, which employ 1.4 million people in the U.S. and hold more than half of all U.S. deposits. The Clearing House is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs and white papers the interests of its owner banks on a variety of systemically important banking issues. The Clearing House Payments Company provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House’s web page at [www.theclearinghouse.org](http://www.theclearinghouse.org).

physical checks. However, it also creates complications when check fraud occurs. The law currently allocates responsibility for the loss associated with check fraud between the paying bank and the depository bank based on a determination of whether an original check was altered or whether the check is a completely counterfeit item. Once the physical check is destroyed, however, it can be nearly impossible to determine from an electronic collection item or substitute check whether the fraud involved the alteration of an existing check or the creation of a counterfeit check. An explicit example of the problem arises when a bank pays a check that has a different payee than when the check was executed by the maker: it may not be clear from a review of the electronic collection item or substitute check whether the check paid was the original check issued but with an altered payee, or rather was a different, counterfeit check. Courts presented with similar facts have reached divergent conclusions about the evidentiary burdens of the parties and which bank should bear the loss for such items. In light of the common industry practice of presenting electronic collection items or substitute checks, and of retaining only a digitized image of the original check, and given the lack of clarity in the law as currently applied, The Clearing House believes the Board should establish a clear default rule.

The Clearing House proposes that when an electronic collection item or a substitute check presented for payment is fraudulent and the paying bank or drawee pays the item, the original check should be presumed to have been altered unless it can be proven by a preponderance of the evidence that the original check was counterfeit and not altered.

**I. The Rules Allocating Fraud Loss Were Developed When Banks Retained Actual Physical Checks.**

In October 2004, the Check Clearing for the 21<sup>st</sup> Century Act (“Check 21”), and the accompanying amendments to Regulation CC that implemented it, changed the nation’s check collection and payment system by permitting banks to truncate the original physical check and retain only a digitized electronic copy.<sup>2</sup> The Board’s Proposed Rules acknowledge and support the continued migration from paper to electronic check processing. Processing and storing only a digitized image of an original check creates efficiency by speeding up the transmission of checks between banks and reducing the costs and risks involved in check processing, such as handling, sorting, storing and transporting physical checks. In situations where reconversion to paper is necessary, a “substitute check” created from the digitized image is considered the legal equivalent of the original check.

The UCC rules that allocate financial responsibility for check fraud between banks were designed to place liability on the bank in the best position to prevent the loss at the lower cost.<sup>3</sup>

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<sup>2</sup> Pub.L. 108-100.

<sup>3</sup> *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, 457 F.3d 619, 622 (7th Cir. 2006)(“When checks were inspected by hand, when copying technology was primitive, and when cancelled checks were stored rather than digitized copies alone retained, this allocation of liability was consistent with the sensible economic principle that the duty to avoid a loss should be placed on the party that can prevent the loss at lower cost.”)

If a problem with a check arises after its deposit, as between a paying and presenting bank, the bank presenting the check for payment bears responsibility if the original check was altered. The underlying principle is that the bank that first receives the altered check is in the best position to detect that an alteration has occurred.<sup>4</sup> When a check is entirely counterfeit, however, the paying bank is responsible if it pays the unauthorized check and cannot rely on the presenting bank's warranty that the check has not been altered.<sup>5</sup>

These loss allocation principles were implemented when banks retained and stored physical copies of checks. If a problem arose, the physical check could be examined and forensic experts could often determine whether an alteration had taken place or whether a check was entirely counterfeit.<sup>6</sup> When the physical check is not available for a detailed inspection, however, experts may not be able to distinguish the difference based on a review of the digitized copy.<sup>7</sup> While the Proposed Rules include operational updates to Regulation CC to account for and encourage the increasing electronification of check processing, they do not include Regulation CC updates to reflect a commensurate modernization of check fraud liability allocation principles.

## **II. Courts That Have Evaluated The Issue of Fraud Liability Allocation Where the Original Check is Unavailable Have Reached Different Conclusions, Creating a Significant Lack of Certainty for Banks.**

Two recent federal circuit court cases, one from the Seventh Circuit Court of Appeals and the other from the Fourth Circuit Court of Appeals, reflect the divergent conclusions courts have reached when required to apply historical loss allocation rules for fraudulent items in the context of modern check retention practices.

In *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, MediaEdge issued a check for \$133,026.00, payable on its account at Wachovia, to CMP Media.<sup>8</sup> An individual named Choi later deposited a check into her account at Foster Bank. Aside from the listed payee, the check Choi deposited was identical to the original check issued by MediaEdge to CMP Media. MediaEdge brought suit against Wachovia for the amount of the check, which had been debited from MediaEdge's account. Wachovia in turn brought a declaratory judgment action against Foster Bank for indemnification in the event MediaEdge prevailed. Wachovia argued that FosterBank breached its presentment warranty by presenting an altered check, which would make FosterBank responsible for the loss. FosterBank countered that Choi may have used

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<sup>4</sup> A presenting bank warrants to a drawee making payment or accepting a draft in good faith that the draft has not been altered. Accordingly, when a check has been altered, the drawee bank may recover for a breach of the warranty of presentment. UCC § 3-417; UCC § 4-208.

<sup>5</sup> A bank is ordinarily liable for charging a customer's account for an item that is not properly payable. UCC § 4-401(a).

<sup>6</sup> Common signs of alteration include smudges, erasures, chemical bleach marks and broken fibers. See *Chevy Chase v. Wachovia*, 208 Fed. App'x. 232, 235 (4th Cir. 2006).

<sup>7</sup> *Id.* ("Without the original, even Wachovia's own forensic expert testified that he could not say, with a reasonable degree of scientific certainty, that the check had been altered rather than forged or copied.")

<sup>8</sup> *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, 457 F.3d 619 (7th Cir. 2006).

“sophisticated copying technology” to produce a completely new check that was identical to the original (but with a new payee), which would make Wachovia responsible for the loss. Because Wachovia destroyed the original check in its ordinary course of business, the check was no longer available for the type of detailed examination necessary to determine whether it was altered or counterfeit. Additionally, Choi had disappeared and, therefore, could not provide insight on the changes. In an opinion by Judge Posner, the court stated that in the event of a “tie” (i.e., when it is unclear whether the check was altered or counterfeit) the check should be presumed altered and the paying bank (Wachovia) should prevail.

In *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*, the court reached a different conclusion.<sup>9</sup> Here, a check for \$341,187.45 drawn on Young & Rubicam’s account at Wachovia was deposited into the account of Kon Pesicka/CJ International at Chevy Chase. The check matched the date, check number and dollar amount of a check Young & Rubicam had issued to Hearst Magazines Division. As in *Wachovia v. Foster BancShares*, it was unclear whether the check deposited by Kon Pesicka/CJ International had been altered or was an entirely new check, identical to the first but with a different payee. Again, the original check had been destroyed and Wachovia’s own forensic expert could not tell from reviewing the digitized image whether the check was altered or was counterfeit. However, the Fourth Circuit Court of Appeals came to a different conclusion than the Seventh Circuit and did not adopt Judge Posner’s rule that the check should be presumed altered. Rather, the court affirmed the district court’s grant of summary judgment in Chevy Chase’s favor, stating that Wachovia did not meet its burden of establishing that the check was altered. Accordingly, the depository bank that presented the check for payment, Chevy Chase, prevailed and Wachovia, which had paid the check, was responsible for the loss.

The rules for assigning liability between depository and paying banks for check fraud were not designed for the current environment, ushered in by technological advances and Check 21, where most checks are digitized and the originals destroyed. As the cases noted above demonstrate, courts have reached divergent conclusions when applying existing liability rules in situations where the original check has been destroyed. This split judicial authority creates significant uncertainty for banks involved in the collection and payment of checks, particularly where the paying bank is presented with an electronic collection item or substitute check. The Clearing House respectfully requests the Board to act to resolve this legal uncertainty.

### **III. The Board Should Amend Regulation CC to Resolve This Uncertainty Regarding Fraudulent Checks.**

The Clearing House believes that Regulation CC,<sup>10</sup> which governs the collection of checks and implemented the provisions of Check 21, is the appropriate vehicle for promulgating a uniform resolution to the evidentiary uncertainty that arises when a fraudulent check that is not the original physical check is presented for payment. To that end, The Clearing House supports

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<sup>9</sup> *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*, 208 Fed. App’x. 232, 235 (4th Cir. 2006).

<sup>10</sup> 12 C.F.R Part 229.

a rule that creates a presumption that a fraudulent check was altered and not counterfeit when the paying bank is presented with an electronic collection item or substitute check for payment and the paying bank pays the fraudulent item. The Clearing House believes it is appropriate, and consistent with state law presentment warranties, to place this burden on the depository bank because (a) as a result of Check 21, the paying bank no longer has the right to demand presentment of original paper checks, (b) most checks today are cleared electronically (without delivery of original paper checks), (c) the depository bank (or its customers through remote deposit capture services offered by the depository bank) is likely to truncate original paper checks (as indicated by the findings of the Federal Reserve Payments Study), (d) the depository bank has the option of retaining original paper checks, balancing the risk of being able to overcome the presumption of alteration against the costs of retaining or processing original checks, and (e) the depository banks' customers received the payment for the fraudulent checks. For the foregoing reasons, we propose that the Board, as part of its evaluation of the Proposed Rules, amend Regulation CC to resolve this issue.

We recommend that Section 229.36 be amended by the addition of a new paragraph to be designated as paragraph (e) as follows:

(e) *Presumption of alteration for certain checks.* When a paying bank or a drawee pays a check that was presented as a substitute check or an electronic collection item, and not the original check, and there is a claim that such check was payable in an amount or to a person not authorized by the drawer, the original check shall be presumed to have been altered unless it can be proven otherwise by a preponderance of the evidence.

#### **IV. The Board Should Adopt the Approach to Paperless Remotely Created Checks (Electronically-Created Items) Proposed by The Clearing House in the October TCH Comment Letter.**


In the October TCH Comment Letter (a copy of which is attached), The Clearing House proposed that the Board amend the definition of "original check" in Regulation CC to include "a remotely created check whether or not originated as paper." The effect of this proposal would be to accord paperless remotely created checks (i.e., remotely created checks ("RCCs") that are never reduced to paper items ("Paperless RCCs")) status as "checks" under Regulation CC. According to the October TCH Comment Letter, Paperless RCCs would continue to be RCCs and, therefore, would be subject to the same transfer and presentment warranties by the depository bank as apply to traditional RCCs.

The Board addressed Paperless RCCs in the Proposed Rules (calling them "electronically-created items") but treated these items as a separate class of instrument rather than including them within the definition of "original checks" under Regulation CC. Consequently, in contrast to RCCs, electronically-created items are not checks, cannot be used to create legally valid substitute checks and are potentially subject to the Electronic Fund Transfer Act and Federal Reserve Board Regulation E, even though electronically-created items are indistinguishable to the depository bank from RCCs that were printed and immediately scanned for image deposit. While acknowledging the existence of electronically-created items under the Proposed Rules is a step in the right direction, The Clearing House continues to be concerned that not according

such items status as checks under Regulation CC leaves unaddressed the principal concerns expressed by The Clearing House in the October TCH Letter. Therefore, The Clearing House respectfully requests that the Board reconsider the October TCH Letter and further revise the Proposed Rules to eliminate the unnecessary risks and uncertainties associated with not including electronically-created items within the definition of "original check" under Regulation CC.

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Thank you for your consideration and review of this proposal. If you have any questions or wish to discuss The Clearing House's letter, please do not hesitate to contact me at 336.769.5314 or [Rob.Hunter@theclearinghouse.org](mailto:Rob.Hunter@theclearinghouse.org).

Yours very truly,  
  
Robert C. Hunter  
Deputy General Counsel



October 28, 2010

Louise L. Roseman  
Director  
Division of Reserve Bank Operations and Payment Systems  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington, D.C. 20551

Re: Proposed Amendment to Regulation CC to Address Paperless Remotely Created Checks

Dear Ms. Roseman:

The Clearing House Association L.L.C.<sup>1</sup> (“The Clearing House”) respectfully submits for consideration by the Board of Governors of the Federal Reserve System (the “Board”) the proposed amendments to Federal Reserve Regulation CC<sup>2</sup> (“Regulation CC”) and Federal Reserve Banks Operating Circular No. 3<sup>3</sup> set forth below to provide for clear treatment under the law of remotely created checks (“RCCs”) that are never reduced to paper items (“Paperless RCCs”).

**I. Issue**

An RCC is a type of check that is drawn on the account of the payor but that is not created by the paying bank and that is not signed by the payor.<sup>4</sup> Instead of the payor’s signature,

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<sup>2</sup> Regulation CC, 12 C.F.R. § 229, *et seq.*

<sup>3</sup> Federal Reserve Banks Operating Circular No. 3, Collection of Cash Items and Returned Checks, Effective July 15, 2008.

<sup>4</sup> Specifically, Regulation CC defines a “remotely created check” as “a check that is not created by the Paying Bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn.” Regulation CC, 12 C.F.R. § 229.2(ff).

an RCC generally bears a statement that the payor authorized the check. The 2006 amendments to Regulation CC expressly defined and addressed RCCs that are printed prior to their deposit with the depository bank (“Paper RCCs”). Increasingly, however, financial institution customers are leveraging technological advances ushered in by the Check Clearing for the 21<sup>st</sup> Century Act<sup>5</sup> (“Check 21”) to deposit RCC images with the depository bank. According to our members, when depository banks accept deposits of RCCs in image rather than in physical (paper) form, it becomes very difficult, if not impossible, for the depository bank to determine whether the image was derived from a Paper RCC or rather originated as a Paperless RCC. Paperless RCCs, while often indistinguishable from Paper RCCs to the depository bank and to any transferring, presenting or paying bank, have uncertain legal status because, as currently defined under Regulation CC, an RCC must be reduced to paper, if even for a moment, in order to achieve definitional status as a “check” under federal law. The uncertain legal status of Paperless RCCs is leading to increased market confusion as well as undue and unnecessary burden on depository banks.

## II. Background

A “check” is defined under Regulation CC as one of four types of demand draft, a United States Postal Service money order or a traveler’s check, and also expressly includes an original check and a substitute check.<sup>6</sup> Regulation CC relies on the Uniform Commercial Code (“UCC”) for the definition of “draft,” which is defined as “a *written* instruction to pay money signed by the person giving the instruction.”<sup>7</sup> The term “original check” is defined in Regulation CC as “the first *paper* check issued with respect to a particular payment transaction,”<sup>8</sup> and the term “substitute check” is defined as “a *paper* reproduction of an original check. . . .”<sup>9</sup> Consequently, to qualify as a “check” for purposes of Regulation CC, an item must have taken paper form at some point in its lifecycle (including if an image of the item is to serve as the basis for creation of a legally valid substitute check). The Board amended Regulation CC on July 1, 2006 to expressly define and address RCCs, including by creating transfer and presentment warranties

<sup>5</sup> 12 U.S.C. §§ 5001–5018.

<sup>6</sup> Regulation CC, 12 C.F.R. § 229.2(k).

<sup>7</sup> U.C.C. §§ 3-103 & 3-104.

<sup>8</sup> *Id.* at § 229.2(wv) (emphasis added).

<sup>9</sup> *Id.* at § 229.2(aaa).



for RCCs that shift liability for unauthorized RCCs to the depository bank.<sup>10</sup> Recognizing the increased use of imaging supported by Check 21 to deposit RCCs, the Board revised Operating Circular No. 3 on July 15, 2008 to distinguish data collected from a Paper RCC (which is eligible for forward collection through the Reserve Bank) from data collected from a Paperless RCC (which is ineligible for forward collection), stating:

Data sent to a Reserve Bank in the form of an electronic item is not an “electronic item” unless the data was captured from a check. By definition, the check from which the data was captured must be paper.<sup>11</sup>

### **III. Proposed Amendments**

Given their exclusion from coverage under Regulation CC and Operating Circular No. 3, the legal status of Paperless RCCs is uncertain because they are not clearly subject to check law even though Paperless RCCs (1) are rarely distinguishable from images captured from Paper RCCs (which are subject to check law), (2) offer better image quality and greater efficiency than is possible when RCCs are required to be printed prior to image capture and processing, and (3) pose no apparent enhanced risks of fraud or other loss relative to Paper RCCs because both instruments are based on authorization rather than payor signature.

The Board amended Regulation CC to place responsibility for the validity of RCCs on the depository bank because the depository bank’s relationship with the payee who deposited the item puts the depository bank in the best position to protect against fraudulent or unauthorized RCCs. Given that the validity of both Paper RCCs and Paperless RCCs is predicated on separate payor authorization and that neither type of item contains a payor signature or other verifiable indication on its face that payment has been authorized, the printing of an RCC does not enhance a depository bank’s ability to determine whether the RCC is fraudulent or validly authorized. Moreover, pursuant to the Regulation CC transfer and presentment warranties, if Paperless RCCs are treated the same as Paper RCCs, liability for losses attributable to an unauthorized Paperless RCC would rest with the depository bank, just as with Paper RCCs.

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<sup>10</sup> Collection of Checks and Other Items By Federal Reserve Banks and Funds Transfers Through Fedwire and Availability of Funds and Collection of Checks, 12 C.F.R. Parts 210 and 229 Regulations J and CC; Proposed Rule, Docket No. R-1226, 70 Fed. Reg. 10,509 (March 4, 2005).

<sup>11</sup> Operating Circular No. 3, supra note 3 at § 1.3(d).

According to our member banks, it is virtually impossible for depository banks to identify and intercept Paperless RCCs while allowing the legitimate deposit of images captured from Paper RCCs. Moreover, the process by which a Payee must print and scan a Paper RCC threatens the quality of the image at both the printing and scanning stages and could result in an illegible or poor quality image that cannot be processed efficiently if at all. Allowing the Payee to instead transmit the original image or Paperless RCC would avoid the need for reimaging and reprocessing of poor quality images and maximize the probability that a high quality image is submitted for processing. Additionally, allowing for the deposit and processing of Paperless RCCs would avoid the cost and time required to print and scan a Paper RCC solely for the purpose of creating a new image that was captured from a physical item.

Further, there is little reason to burden depository banks with the task of trying to distinguish Paperless RCCs from Paper RCCs or requiring Payees to print and scan a Paper RCC before depositing the image as there appears to be no incrementally increased risk or harm created by treating Paperless RCCs on equal footing with Paper RCCs under check law. Rather, requiring a payee to create a Paper RCC to serve as a physical item for image capture rather than allowing the deposit of the RCC as a Paperless RCC may actually increase risk. Specifically, printing an RCC creates a paper item that may be more susceptible to unauthorized access due to the additional handling and physical disposition required of the Paper RCC relative to a Paperless RCC. In addition, generating a Paper RCC and scanning the item rather than depositing the RCC as a Paperless RCC increases the risk of duplicate item presentment. Printing and scanning an RCC to create an image for deposit results in two live items, one electronic and one paper, and thereby increases the risk that both the image and the Paper RCC may be presented for payment and that the Paper RCC may be scanned and deposited multiple times. These risks would be mitigated if the payee were permitted to deposit the Paperless RCC directly with the depository bank.

For the foregoing reasons, we propose that the Board amend Regulation CC and Operating Circular No. 3 to afford Paperless RCCs the same treatment as the Board afforded to Paper RCCs through the 2006 Amendments to Regulation CC.

A. Regulation CC

We recommend that the definition of “original check” in Section 229.2(w) of Regulation CC be amended as follows:

*Original check* means the first paper check issued with respect to a particular payment transaction; or a remotely created check whether or not originated as paper.

Adopting the proposed amendment to the definition of “original check” to include RCCs “whether or not originated as paper” will accord Paperless RCCs status as valid “checks” under Regulation CC, a necessary predicate to the valid processing of such items under Operating Circular No. 3. Paperless RCCs would remain RCCs, subjecting the depository bank to the transfer and presentment warranties associated with such items. Moreover, amendment of the definition of “original check” to include RCCs “whether or not originated as paper” will bring paper reproductions of Paper RCCs and Paperless RCCs within the meaning of “substitute check” under Regulation CC, and thus bring such paper reproductions within the substitute check warranties and substitute check indemnity provisions of Regulation CC. These provisions are among the terms relied upon in Federal Reserve Regulation J and Operating Circular No. 3 in determining check and item handling rights and responsibilities of the Reserve Banks. Thus, revising the definition of “original check” under Regulation CC to include RCCs “whether or not originated as paper” would enhance continuity and consistency among Regulation J, Operating Circular 3 and Regulation CC in the treatment of Paper RCCs and Paperless RCCs, while lifting the unnecessary burden on depository banks of performing the virtually impossible task of identifying and intercepting Paperless RCCs and eliminating the added risks of unauthorized access and duplicate presentment created by requiring that all RCCs be reduced to paper.

B. Operating Circular No. 3

We recommend that the definition and description of “electronic item” as set forth in Section 1.3(d) of Operating Circular No. 3 be amended as follows:

- (d) data captured from a cash item or a returned check may be sent in the form of an “electronic item,” (as that term is defined in Regulation J). To meet the definition of an electronic item, the data must include an electronic image of

a check and information describing that check and must conform to the Reserve Bank's technical requirements for processing electronic items, as amended from time to time. Data sent to a Reserve Bank in the form of an electronic item is not an "electronic item" unless the data was captured from a check. ~~By definition, the check from which the data was captured must be paper.~~ A "purported electronic item" means an electronic image of a check and information describing that check that are sent to the Reserve Bank to be handled as an electronic item but that fail to conform to the Reserve Bank's technical requirements for processing electronic items.

Combined with the proposed changes to Regulation CC above, such amendment will bring Paperless RCCs within the meaning of an "electronic item" eligible for forward collection pursuant to Operating Circular No. 3.

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Thank you for your consideration and review of this proposal. We would like to meet with you and your staff to discuss the proposal in detail and I will be calling in the near future to determine a convenient meeting time. We look forward to working with you on this issue.

Yours very truly,

A handwritten signature in black ink, appearing to read "Robert C. Hunter", with a long horizontal flourish extending to the right.

Robert C. Hunter  
Senior Vice President & Senior Counsel

cc: Stephanie Martin, Associate General Counsel