RULE L1

PROCEDURES PERTAINING
TO THE DEFAULT OF A DIRECT CLEARER

2018 CANADIAN PAYMENTS ASSOCIATION

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RULE L1 – PROCEDURES PERTAINING TO THE DEFAULT OF A DIRECT CLEARER

IMPLEMENTED

March 31, 1994

AMENDMENTS PRE-NOVEMBER 2003


AMENDMENTS POST-NOVEMBER 2003

1. Amendments to reflect consistency with the new CPA Payment Items and ACSS By-law, approved by the Board November 27, 2003, effective January 27, 2004.

2. Addition of Section 12 (b) iii) approved by the Board December 1, 2004, effective February 3, 2005.

3. Amendments made to reflect use of defined term “Representative” approved by the Board February 23, 2006 effective April 24, 2006


6. Amendment to replace references to “General Manager” with “President”, consequential to amendments to the Canadian Payments Act (Bill C-37) that came into effect on March 1, 2010.

7. Amendments to reflect the removal of certain default and un-winding procedures, consequential to amendments to By-law No. 3 – Payment Items and ACSS, which came into effect on August 17, 2012. Approved by the Board October 3, 2013, effective December 2, 2013.


9. Amendments to accommodate changes associated with the ACSS Interim Credit Risk Model. Approved by the Board November 30, 2017, effective March 12, 2018.
Introduction

1. This Rule outlines the procedures for implementing subsection 50(2) and sections 53 through 57 of By-law No. 3 – Payment Items and ACSS in the event of the Default of a Direct Clearer.

Scope

2. a. These procedures shall be followed by each Member in the event of a Default of a Direct Clearer.

   b. For greater certainty, this Rule only applies to Default as defined in subsection 3(f), and does not include intervention by a regulator, liquidator and/or receiver.

Definitions

3. In this Rule, unless the context otherwise requires:

   a. “ACSS Collateral Pool” means the aggregate amount of Collateral, as determined in accordance with Rule L3: Collateral, that is required to be pledged and maintained by all Direct Clearers under subsection 34.1(2) of By-law No.3 – Payment Items and ACSS;

   b. “Additional Contribution” means any amount payable by a surviving Direct Clearer or the Bank of Canada pursuant to subsection 57.01(2) of By-law No.3 – Payment Items and ACSS, upon the Default of a Direct Clearer;

   c. “Bank Rate” means the minimum rate at which the Bank of Canada is prepared to make loans or advances, as published by it from time to time;

   d. “Collateral” means any form of security that is designated by the Bank of Canada, in written communications with Direct Clearers, to be acceptable as security for advances of funds by the Bank of Canada and includes securities of a type designated by the Bank of Canada as acceptable as Collateral for advances and funds on deposit with the Bank of Canada;

   e. “Collateral Pool Pledge” means the amount of Collateral, as determined in accordance with Rule L3: Collateral, that each Direct Clearer is required to pledge and maintain with to the Bank of Canada under subsection 34.1(2) of By-law No.3 – Payment Items and ACSS and allocate solely for the purpose of securing an advance from the Bank of Canada to enable settlement under section 50 of that By-law;

   f. “Default” means a default of a Direct Clearer within the meaning of subsection 53(1)(a) or (b) of By-law No.3 – Payment Items and ACSS;
g. “Default Contribution” means the amount payable by a surviving Direct Clearer pursuant to subsection 57(2) of By-law No.3 – Payment Items and ACSS, upon the Default of a Direct Clearer;

h. “Direct Clearer” means a Member, other than the Bank of Canada, that on its own behalf Exchanges Items and makes entries into the ACSS. For greater certainty, references to Direct Clearers in this Rule include Group Clearers;

i. “Large Value Transfer System” has the same meaning as in section 1 of By-law No.7, Respecting the Large Value Transfer System;

j. “Multilateral Net Debit Position” or “MNDP” means the Clearing Balance of a Direct Clearer or Indirect Clearer that is in a net owing position, as that Clearing Balance is established by the ACSS in the case of a Direct Clearer or by an Indirect Clearer’s Clearing Agent.

k. “Official Contact” means the person designated by a Member to be its representative for the purpose of receiving notice pursuant to this Rule;

l. “Purge” and “Purging” mean the process of deleting AFT Transactions, and EDI Payment Items that have been Exchanged with a defaulting Direct Clearer for Clearing and Settlement subsequent to the ACSS Cycle for which Default has occurred and are residing in or destined for Members’ warehouses; and

m. “Settlement Account” means the account that is established and maintained by each Direct Clearer, at the Bank of Canada, or by each Indirect Clearer, with its Clearing Agent, for the purpose of Settlement.

**Notice of Default from Bank of Canada**

4. Where a Default has occurred, the Bank of Canada shall give notice of the Default to the President pursuant to subsection 53(2) of By-law No. 3 – Payment Items and ACSS.

Such notice shall:

a. in the case of a Default within the meaning of subsection 53(1)(a) of By-law No. 3 – Payment Items and ACSS, specify the shortfall between the amount of advance that is required to permit Settlement of the Direct Clearer’s MNDP and the amount of advance that the Direct Clearer is able to secure with the Collateral that it has pledged to the Bank of Canada and allocated for ACSS purposes;

b. in the case of a Default within the meaning of subsection 53(1)(b) of By-law No. 3 – Payment Items and ACSS, specify the amount by which the Direct Clearer has failed to make the required Collateral Pool Pledge.
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Notification by CPA to Members and Others

5. a. Upon being notified by the Bank of Canada pursuant to section 4, the President shall, in accordance with subsection 5(b), and without liability to the President, the CPA or any of its employees, immediately give notice of the Default to:

   i. the Official Contact of each Direct Clearer;
   ii. the CPA Board of Directors;
   iii. the relevant regulatory authority(ies); and
   iv. payment services networks such as those defined in Rules E1, E2 and E4.

b. For the purpose of subsection 5(a):

   i. the notice shall be provided or confirmed by telephone and electronic mail to all those entitled to notice under subsection 5(a);
   ii. a reasonable effort shall be made to ensure notice of the Default is received by each surviving Direct Clearer; and
   iii. notice of the Default shall specify the effective date of the Default, the specific ACSS Cycle for which Default has occurred and whether the Default is within the meaning of subsection 53(1)(a) or (b) of By-law No. 3 – Payment Items and ACSS.

c. It is the responsibility of each Direct Clearer to ensure that its Official Contact Information, as maintained by the CPA, is accurate and up to date.

Notification – Liquidator

6. Where the President is officially notified of the appointment of a liquidator or trustee in respect of a Direct Clearer, the President shall immediately:

   a. give notice of such appointment to the Official Contact of each Direct Clearer; and
   b. give notice to the liquidator or trustee of the requirements as set out in section 31 of the Act.

Automated Clearing Settlement System (ACSS) and U.S. Bulk Exchange (USBE) System

7. Immediately upon receiving notice of a Default pursuant to section 4, and without liability to the President, the CPA or any of its employees, the President shall block the defaulting Direct Clearer’s access to both the ACSS and the USBE Systems for the cycle.
immediately following the cycle for which Default has been declared and shall also effect an emergency update to the Financial Institution File.

Responsibilities of CPA Members

8. a. Upon receipt of the notice of Default, pursuant to subsection 5(a), each Direct Clearer shall:
   i. Give notice to each of its Branches, internal departments and all Indirect Clearers for which it acts as Clearing Agent or, in the case of a Group Clearer, to all the entities belonging to the Group for which it acts as Group Clearer, to immediately stop accepting, for clearing purposes, all Items drawn on, payable by or payable to, the defaulting Direct Clearer;
   ii. Immediately "block" each of its systems or processes that Exchange payments with the defaulting Direct Clearer; and
   iii. Immediately "block" each of its systems or processes that Exchange payments settled using a defaulting Direct Clearer acting as a Settlement Intermediary.

Representative of a non-participating Direct Clearer

9. Where a defaulting Direct Clearer acts as Representative for a non-participating Direct Clearer and processes and Exchanges the Payment Items of the non-participating Direct Clearer as though they were its own, any amount arising from this arrangement that is due by the defaulting Direct Clearer to the non-participating Direct Clearer and for which no ACSS entry has been made at the time of declaration of Default shall be credited to the Settlement Account of the non-participating Direct Clearer by means of an adjustment to its Clearing Balance for the day of Default at the appropriate Regional Exchange Point. The amount of the adjustment shall be communicated in writing from the non-participating Direct Clearer to the Bank of Canada.

Treatment of Payment Items

10. a. All obligations arising from the Exchange or intended Settlement of Payment Items involving a defaulting Direct Clearer for the ACSS Cycle for which Default has occurred will be settled in accordance with sections 57, 57.01 and 57.02 of By-law No. 3 – Payment Items and ACSS.

    b. All Payment Items of the defaulting Direct Clearer that are value dated for an ACSS Cycle subsequent to the day of Default shall be Purged.
c. Listings of all Items that have been Purged shall be forwarded to the liquidator or trustee, in order that the liquidator or trustee can inform the affected Indirect Clearers.

U.S. Dollar Items

11. Upon receipt of a notice of Default pursuant to subsection 5(a), each surviving Direct Clearer which is a participant in the Bulk Exchange of U.S. dollar Items (refer Rules K1 and K8) should determine, as soon as possible, whether any settlement that is due to it in New York from the defaulting Direct Clearer with respect to Items exchanged via the U.S. Bulk Exchange has been received. Where such settlement has not been received, refer to section 27 of Rule K1 and section 13 of Rule K8.

Calculation of Default Contributions and Additional Contributions

12. Upon receipt by the President of a notice from the Bank of Canada pursuant to section 4(b) that a Direct Clearer has defaulted within the meaning of subsection 53(1)(a) of By-law No. 3 – Payment Items and ACSS and following consultation between the President and the Bank of Canada, the CPA shall calculate, in accordance with the methodology and formulas set out in Appendix 2, the amount of Default Contribution and Additional Contribution, if any, to be made by each surviving Direct Clearer and the Bank of Canada. The aggregate amount of Default Contributions payable by all surviving Direct Clearers shall not exceed the amount of the ACSS Collateral Pool, less the amount of the Collateral Pool Pledge of the defaulting Direct Clearer.

Notice of Default Contributions and Additional Contributions

13. a. With respect to any Default Contribution and Additional Contribution that is determined to be payable by a surviving Direct Clearer pursuant to section 12, the President shall instruct the surviving Direct Clearer to furnish to the Bank of Canada an amount equal to its Default Contribution and Additional Contribution (if any), within such time period as is specified by the President.

b. With respect to any Additional Contribution that is determined pursuant to section 12 to be payable by the Bank of Canada, the President shall instruct the Bank of Canada to make its Additional Contribution within such time period as is specified by the President.

c. For the purpose of subsections 13(a) and (b):

   i. the President’s instructions shall be sent by electronic mail to the Official
Contact of each surviving Direct Clearer and to the Director, Payment and Settlement Operations of the Bank of Canada (Appendix I contains a pro forma sample of the required communications); and

ii. the President shall give notice to the Director, Payment and Settlement Operations, of the Bank of Canada, either by electronic mail or by hand-delivered letter, of the amount of Default Contribution to be made by each surviving Direct Clearer and the amount of Additional Contribution to be made by each surviving Direct Clearer and the Bank of Canada, as the case may be, as well as the total of all such amounts, and the deadline for making these Contributions.

Methods of Making Default Contributions and Additional Contributions

14. a. Upon receiving an instruction from the President pursuant to subsection 13(a) to make a Default Contribution or an Additional Contribution, a surviving Direct Clearer shall, within the time period specified in the instruction, make the Default Contribution and Additional Contribution (if any) in accordance with the following:

i. to the extent that it has a sufficient positive balance in its Settlement Account, transferring funds from its Settlement Account to the Settlement Account of the defaulting Direct Clearer; or

ii. to the extent that it does not have a sufficient positive balance in its Settlement Account, by completing a payment to the Bank of Canada through the Large Value Transfer System or obtaining an advance from the Bank of Canada, and the Bank of Canada crediting the surviving Direct Clearer’s Settlement Account in the amount of the payment or advance and subsequently making the account entries to transfer that amount from the Settlement Account of the surviving Direct Clearer to the Settlement Account of the defaulting Direct Clearer.

b. Upon receiving an instruction from the President pursuant to subsection 13(b) to make an Additional Contribution, the Bank of Canada shall, within the time period specified in the instruction, make its Additional Contribution by crediting the Settlement Account of the defaulting Direct Clearer in the amount of its Additional Contribution.

For the purpose of subsections 14(a) and 14(b), the notice received by the Bank of Canada from the President shall constitute sufficient authority to debit the Settlement Account of each surviving Direct Clearer and credit the account of the
Defaulting Direct Clearer in the amount of the Default Contributions and Additional Contributions.

Settlement following Default Contributions and Additional Contributions

15. Where the account entries, payments, advances, deposits and transfers between Settlement Accounts made pursuant to section 14 to effect Default Contributions and Additional Contributions enable settlement of the Clearing Balance of the defaulting Direct Clearer, the Bank of Canada shall effect settlement by making the appropriate debit or credit entry into each Direct Clearer’s Settlement Account.

Interest on Default Contributions and Additional Contributions

16. Amounts paid by Direct Clearers and the Bank of Canada for Default Contributions and Additional Contributions shall bear interest at the Bank Rate, minus one quarter of one percent (0.25%) or such other rate as established by the President in consultation with Direct Clearers and the Bank of Canada. If there is more than one Bank Rate published during the period in which interest is owing, then one interest rate is to be used in the interest calculation. This interest rate will be the average of all Bank Rates published during the period in which interest is owing.
To: Official Contact
Surviving Direct Clearer

or To: The Director, Payment and Settlement Operations
Bank of Canada

Pursuant to section 13 of CPA Rule L1, the Canadian Payments Association hereby notifies you of the amount of Default Contribution and Additional Contribution (if any) to be made by your institution pursuant to Section 12 of CPA Rule L1. These amounts are to be credited by the Bank of Canada to the Settlement Account of ______________ (name of defaulting Direct Clearer) for value as of __________ (time of day) on __________ (date of default). These amounts have been calculated in accordance with the methodology and formulas set out in Appendix 2.

Amount of Default Contribution: $________________________

Amount of Additional Contribution: $________________________

Total of Default Contribution and Additional Contribution: $________________________

The Contribution(s) set out above are to be made by your institution by no later than __________ (time of day) on __________ (date of default).

________________________________
President, CEO,
Canadian Payments Association
Default Contribution (Direct Clearers only)

1. By surviving Direct Clearers that have sent value to the defaulting Direct Clearer ("Surviving Direct Clearers with Value Sent")

   a) First round of calculation of Default Contribution

      The Default Contribution of a Surviving Direct Clearer with value sent by entering into the ACSS, during the ACSS Cycle in which the Default occurred, Payment Items that are drawn on or payable by the defaulting Direct Clearer (the “Value Sent”), is equal to the lesser of:

      (i) the amount of the surviving Direct Clearer’s Collateral Pool Pledge; and
      (ii) the shortfall between the MNDP of the defaulting Direct Clearer and the amount of Collateral pledged by the defaulting Direct Clearer to the Bank of Canada and allocated for ACSS purposes (the “Defaulter’s Shortfall”) multiplied by the ratio of the Value Sent by the Surviving Direct Clearer to the Value Sent by all surviving Direct Clearers.

      Default Contribution = \( A \times \frac{B}{C} \)

      where

      \( A \) = Defaulter’s Shortfall;
      \( B \) = Value Sent by the surviving Direct Clearer; and
      \( C \) = Total of Value Sent by all surviving Direct Clearers.

   b) Subsequent round(s) of calculation of Default Contribution

      If the Defaulter Shortfall is not fully covered by the sum of the Default Contributions calculated by the CPA in the first round of calculation described in subsection 1(a), subsequent round(s) of calculation of further Default Contributions by surviving Direct Clearers with Value Sent is required. Such subsequent round(s) of calculation will be executed until the sum of the Default Contributions of all Surviving Direct Clearers with Value Sent is:

      (i) sufficient to cover the Defaulter’s Shortfall, or
(ii) equal to the sum of the value of the Collateral Pool Pledge by Surviving Direct Clearers with Value Sent.

Subsequent round(s) of Default Contribution will be required from those Surviving Direct Clearers with Value Sent whose Collateral Pool Pledge exceeds the sum of their Default Contributions from previous round(s) of calculation ("Remaining Surviving Direct Clearers with Value Sent").

In any subsequent round(s) of calculation, the sum of all previous rounds’ calculated Default Contributions of Surviving Direct Clearers with Value Sent is subtracted from the Defaulter’s Shortfall before applying the ratio of any Value Sent by the Remaining Surviving Direct Clearer with Value Sent to the Total of Value Sent by all Remaining Surviving Direct Clearers with Value Sent.

$$\text{Default Contribution subsequent round} = D \times \frac{E}{F}$$

where

- $D =$ Defaulter’s Shortfall less the sum of all previous rounds’ calculated Default Contributions for Surviving Direct Clearers with Value Sent;
- $E =$ Value Sent for Remaining Surviving Direct Clearer with Value Sent; and
- $F =$ Total of Value Sent by all Remaining Surviving Direct Clearers with Value Sent

If the sum of the Default Contributions of all Surviving Direct Clearers with Value Sent is sufficient to cover the Defaulter’s Shortfall, those surviving Direct Clearers that have no Value Sent to the defaulting Direct Clearer shall not be required to make a Default Contribution or Additional Contribution.

2. By surviving Direct Clearers that have not sent value to the defaulting Direct Clearer ("Surviving Direct Clearers with No Value Sent")

If the sum of the Default Contributions of all Surviving Direct Clearers with Value Sent is not sufficient to cover the Defaulter’s Shortfall those Surviving Direct Clearers with No Value Sent shall be required to make a Default Contribution. The Default Contribution of a Surviving Direct Clearer with No Value Sent is equal to the lesser of:

a) the amount of the Collateral Pool Pledge of the Surviving Direct Clearers with No Value Sent;

b) the difference between the Defaulter’s Shortfall and the sum of the Default Contributions of all Surviving Direct Clearers with Value Sent multiplied by the ratio of the amount of Collateral Pool Pledge of the Surviving Direct Clearer with No
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Value Sent to the sum of the Collateral Pool Pledges of all Surviving Direct Clearers with No Value Sent.

Default Contribution = \( G \times \frac{H}{I} \)

where

\( G \) = The difference between the Defaulter’s Shortfall and the sum of the Default Contributions of all Surviving Direct Clearers with Value Sent;

\( H \) = The amount of the Collateral Pool Pledge of the Surviving Direct Clearer with No Value Sent; and

\( I \) = The sum of the Collateral Pool Pledges of all Surviving Direct Clearers with No Value Sent.

The sum of the Default Contributions of all surviving Direct Clearers under sections 1 and 2 of this Appendix 2 shall not exceed the amount of the ACSS Collateral Pool less the amount of the Collateral Pool Pledge of the defaulting Direct Clearer. Additional Contributions under section 3 shall only be required if the total amount of Default Contributions that is required to cover the Defaulter’s Shortfall is greater than the amount of the ACSS Collateral Pool less the amount of the Collateral Pool Pledge of the defaulting Direct Clearer.

3. Additional Contribution (Direct Clearers and Bank of Canada)

The Additional Contribution of a surviving Direct Clearer or the Bank of Canada is equal to the difference between the amount of the Defaulter’s Shortfall and the sum of the Default Contributions of all surviving Direct Clearers under sections 2 and 3 (such difference, the “Residual Shortfall”), multiplied by the ratio of the Value Sent by the surviving Direct Clearer or the Bank of Canada to the Value Sent by all surviving Direct Clearers and the Bank of Canada:

\[
\text{Additional Contribution} = J \times \frac{B}{C}
\]

where

\( B \) = Value Sent by the surviving Direct Clearer or Bank of Canada;
\( C \) = Total of Value Sent by all surviving Direct Clearers and Bank of Canada; and
\( J \) = Residual Shortfall.