CIRCULAR

SEBI/HO/MRD2_DCAP/P/CIR/2022/165 **November 30, 2022**

To

All Recognized Stock Exchanges
All Recognized Clearing Corporations

Dear Sir/ Madam,

Sub: Net Settlement of Cash segment and Futures & Options (F&O) segment upon expiry of stock derivatives

SEBI, vide circular no. SEBI/HO/MRD/DP/CIR/P/2018/67 dated April 11, 2018, has inter-alia mandated physical settlement of stock derivatives, upon expiry of such derivatives, in a phased manner. Further, it mentioned that the risk management framework, settlement mechanism and other procedures of the cash segment shall be applicable when a stock derivatives devolves into physical settlement.

2. With a view to provide better alignment of cash and derivatives segment, mitigation of price risk and bringing in netting efficiencies for market participants; it has been decided, in consultation with the Secondary Market Advisory Committee (SMAC) of SEBI, to introduce the mechanism of Net Settlement of cash segment and F&O segment upon expiry of stock derivatives.

3. The details of the said Net Settlement Mechanism are as under:

    3.1. The obligations arising out of cash segment settlement and physical settlement of F&O segment, upon expiry of stock derivatives, shall be settled on net basis as against the current approach of settling such obligations separately.

3.2. The benefit of netting (merged settlements) shall be available to investors whose trading member (TM) clears trades in F&O segment and cash segment through the same clearing member (CM) i.e. benefit of netting shall be available to investors who trade and clear through the same TM-CM combination in Cash and F&O segment. However, investors whose TM clears trades through different CM / Clearing Corporation (CC) will not be able to avail the benefit of netting.

3.3. Netting of settlement obligations of cash segment and physical settlement of F&O segment shall not be available for the institutional investors (including all categories of Foreign Portfolio Investors) since the extant regulatory framework specifies that all transactions by the institutional investors (including all categories of Foreign Portfolio Investors) in cash market should be backed by delivery.

3.4. Netting of settlement shall be available for non-institutional Custodial Participants (CPs) clearing through the same entity registered both as a custodian in cash market and as a CM in F&O segment, except and otherwise for those investors/ clients/ participants (for instance Portfolio Managers- PMS) which have been mandatorily directed to enter into delivery backed transactions only.

3.5. Under the Net Settlement mechanism, netting of delivery obligations shall be only for the purpose of settlement. Therefore, Securities Transaction Tax (STT) and Stamp Duty shall continue to be computed, levied and reported on a segment wise level.

3.6. CCs shall continue to settle obligations on net basis at CM level. Further, CCs shall continue to maintain segment-wise default waterfalls, regardless of a single settlement across segments. The losses, if any, in case of default of a CM to CC shall be computed on the basis of the segment-wise obligation of CM to CC, on a pro-rata basis.

3.7. An illustration highlighting the benefit of Net Settlement is placed as **Annexure 1**.

4. The circular shall come into force from March 2023 expiry of F&O contracts.

5. Stock Exchanges/Clearing Corporations are directed to:

    a. take necessary steps to put in place systems for implementation of the circular, including necessary amendments to the relevant bye-laws, rules and regulations;
    b. bring the provisions of this circular to the notice of their members and also disseminate the same on their websites; and
    c. communicate to SEBI the status of implementation of the provisions of this circular.

6. This circular is being issued in exercise of the powers conferred under Section 11(1) of the Securities and Exchange Board of India Act, 1992, read with Section 10 of the Securities Contracts (Regulation) Act, 1956 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

7. This circular is available on SEBI website at www.sebi.gov.in at “Legal→Circulars”.

Yours faithfully

(Vishal Shukla)
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Annexure 1

Illustration:

Suppose an investor has following positions:

1. Long In The Money (ITM) put option of strike price Rs.110, with underlying settlement price as Rs.100.
2. A cash market trade done on the expiry day, with security purchased at Rs. 101.

In this case, under the existing mechanism of separate settlements of cash and F&O segments, the settlement would happen in the following manner:

1. The investor will make funds pay-in of Rs. 101 in cash segment.
2. The investor will receive pay-out of the stock in cash segment.
3. The investor will deliver the stock in F&O settlement.
4. The investor will receive Rs. 110.

Further, under the existing mechanism, margin would be applicable on delivery obligations in cash segment and F&O segment separately.

Under the Net Settlement mechanism, there would be no need for the investor to arrange for funds of Rs. 101, i.e., the investor would have a net pay-out of Rs. 9 and would not have any requirement of securities pay-in or pay-out. Further, there would be no margin requirement, after expiry, since there would be only cash receivable and no delivery obligation.

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