

POLICY FRAMEWORK FOR ORDERLY WINDING DOWN OF CRITICAL OPERATIONS AND SERVICES

NCL		Policies and Procedures
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Owner		Compliance Team
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2.0	April 30, 2024	Annual Review of Policy	Approved by Governing Board
1.0	March 15, 2020	New Policy	Approved by Governing Board

1 Objective

SEBI vide its circular reference number SEBI/HO/MRD/MRD-PoD-3/P/CIR/2022/173 dated December 16, 2022 has advised clearing corporations (CCs) to put in place a policy framework to identify scenarios which may potentially prevent the CC to provide its critical operations and services as a going concern; identify critical services whose disorderly discontinuation will have a disruptive impact on the financial system; and formulate a standard operating procedure (SOP) to ensure that in the event of winding down, such critical operations and services are continued for adequate period that will enable market participants to put in place alternative arrangements so as to avoid any disruption. The SEBI requirements also advise CCs to maintain adequate capital so as to be able to continue providing its critical operations and services during the winding down period.

In accordance with the above requirement, this policy framework identifies potential scenarios leading to winding down, identifies critical operations and services that must be continued to be provided in order to prevent disruption to the financial system, puts in place standard operating procedure for winding down, identifies capital to be maintained to ensure continuance of critical operations and services. The framework also puts in place the governance mechanisms including review and implementation of the policy.

2 Potential scenarios

The scenarios which may potentially prevent NSE Clearing Ltd. (NCL) from being able to provide its critical operations and services and may require winding down of such critical operations and services can be broadly classified into three categories: (i) voluntary winding down, (ii) involuntary winding down – further classified into two sub-scenarios as (ii-a) being on account of member defaults or (ii-b) due to non-default losses, and (iii) regulatory actions. Each of these scenarios are discussed in the subsequent sections.

2.1 Voluntary winding down

This is a potential scenario where NCL has no financial distress and is able to meet all its financial obligations, to clearing members or any other parties in full, but has decided to wind down its activities, including its critical operations and services as a strategic or business decision.

2.2 Involuntary winding down

2.2.1 Losses due to clearing member defaults

This is a potential scenario of clearing member(s) defaults leading exhaustion of default management resources maintained by NCL and consequently, a failure of NCL to fulfil its obligations towards other non-defaulting Clearing Members and/or constituents.

NCL has put in place a robust risk management framework with upfront margin collection, individual client-wise margining and real-time monitoring. The initial margin requirements are calibrated for 99.9% confidence, with extreme loss margin providing additional cover for the tail risk. Even if market conditions

were to be more extreme than those envisaged in the margin models and clearing member(s) were to default, NCL has put in place a Core Settlement Guarantee Fund (Core SGF) that is sufficient to cover for losses arising out of default of top two clearing members with highest exposure under extreme but plausible market conditions beyond the target confidence level of the margin model. In addition to the Core SGF, other prefunded/committed financial resources are also available for utilization as part of the default waterfall.

Despite the robust risk management framework, residual risks, however unlikely, remain. If unprecedented extreme market volatility and price movement is faced during management of default of one or large number of clearing members, such that the cover offered by margins and other default management resources becomes insufficient; NCL may have to resort to pay-out haircut as part of the last stage of the default waterfall. In case of default on account of institutional transactions in cash market, only the other default management resources except margins will be available prior to pay-out haircut, since such transactions are exempt from margin requirements in accordance with SEBI guidelines.

After pay-out haircut, any subsequent usage of funds by NCL will be with prior SEBI approval, and NCL will be required to replenish the default management resources. This may involve raising of additional capital, which NCL may be unable to complete. In such scenario, the ability of NCL to provide its critical operations and services on an ongoing basis will be hampered.

2.2.2 Losses due to reasons other than clearing member defaults

This scenario is the occurrence of events that may potentially cause financial distress to NCL and hamper its ability to meet obligations towards clearing members or other creditors, even if there has not been any default by any clearing member. Such events may include the following:

2.2.2.1 Systemic risk

NCL operates in a highly interconnected environment, and operates closely with other MIs including exchanges, depositories, and other CCs under interoperability.

Any failure at other CCs with whom NCL has interoperability arrangements can affect functioning of NCL. The inter-CC exposure is collateralized with same margin requirements as applicable to the members, and an additional capital over and above margins is also required to be provided. Uncovered exposure to linked CC is therefore more unlikely than clearing members, since in case of any default faced by the linked CC, such linked CC will first exhaust its own margin and other default management resources; and may default to NCL if there is shortfall despite these resources. A residual risk of default of linked CC affecting NCL, however remote, remains.

NCL is highly interconnected with other MIs including exchanges and depositories for effective functioning of its risk management system. Failure of other MIs to fulfill their operational obligations can impact effective risk management at NCL.

Some entities may be having multiple relationships: e.g., a bank may be a clearing member, clearing bank, liquidity provider, empaneled for issuance of collateral etc. Any failure of such entity can adversely impact NCL's operations.

2.2.2.2 Legal and regulatory risks

Legal and regulatory risks, which include events such as unexpected application of a law or regulation that renders contracts or rules or operational procedures of NCL unenforceable, orders by judicial and regulatory authorities which resulting on in freezing of assets and affect the recovery of dues by NCL, or orders against NCL itself resulting in legal liabilities may all lead to losses and threaten the operations of NCL as a going concern.

2.2.2.3 Credit risks

Other than clearing members, NCL has credit exposures against clearing banks as well as empaneled banks for issuance of collateral. NCL has put in place prudent empanelment criteria, mechanisms for regular assessment for creditworthiness of such banks, and multiple prudential limits. However, despite these efforts, a credit event may occur at such banks which can cause losses for NCL, which will affect NCL's ability to provide its critical operations and services.

2.2.2.4 Investment risks

The funds received by NCL from clearing members, the corpus of the Core SGF, as well as the own funds of NCL (other than contribution to Core SGF) are invested in financial assets with low credit, liquidity and market risks, in accordance with the prudent investment policy framed by NCL and in compliance with the applicable regulations.

If large losses were to occur on such investments, NCL may be unable to return the funds received from clearing members, or unable to maintain the minimum required capital or Core SGF. Such an event may affect NCL's ability to provide its critical operations and services.

2.2.2.5 General business and operational risks

Other than the aforementioned scenarios, general business risk (lower revenues or higher expenditures), as well as operational risks may lead to losses and affect the ability of NCL to provide its critical operations and services.

Further, in accordance with the aforementioned SEBI circular a CC shall be required to continuously meet the annual clearing turnover, aggregated across segments, including by way of interoperability, of at least INR 1,000 Cr. per annum or any other amount as may be specified by SEBI from time to time. In case the NCL fails to meet the aforesaid requirement for two consecutive years, NCL shall be liable to exit and accordingly, apply for orderly winding down of its critical operations and services.

2.3 Regulatory actions

In accordance with the SEBI circular on the framework for orderly winding down of CCs, SEBI may direct NCL to wind down its critical operations and services for inability to meet annual turnover requirement, non-compliance of either the conditions of grant of recognition or renewal, wherever applicable, or any other condition under the applicable laws.

3 Identification of critical activities

3.1 Activities undertaken by NCL

NCL is a systemically important financial market infrastructure, recognized as qualified central counter party (QCCP) by SEBI. NCL is the largest clearing corporation under supervision of SEBI and disorderly termination of its activities can have adverse effect on the financial system. As a CCP, NSE Clearing faces multiple risks – including risk of member defaults and various other risks as described in the preceding section. NSE Clearing maintains a prudent, robust and comprehensive risk management framework to mitigate these risks. NSE Clearing, as an organization, is structured in alignment with the SEBI regulations and guidelines and governance requirements for clearing corporations. NSE Clearing also maintains sufficient net worth in the form of liquid financial assets to mitigate various risks that it is exposed to. SEBI has specified risk-based capital and net worth requirements for clearing corporations, and NSE Clearing maintains adequate net worth to meet these requirements at all times. NSE Clearing is highly interconnected with other MIIs, providing clearing and settlement services to three exchanges viz. NSE, BSE and MSE, providing interoperability with ICCL, and settling through two depositories viz. NSDL and CDSL.

The primary activity of NCL include providing counter party guarantee and clearing and settlement services for various exchange traded products under its recognition as clearing corporation. NCL is also involved or in process of being involved in some other additional activities undertaken on behalf of other recognized clearing corporations in accordance with regulatory guidance/approval. The activities that NCL is engaged are provided below.

1. Central counterparty clearing: NCL offers full fledged central counterparty clearing services in multiple asset classes/segments including cash market and allied products, equity derivatives, currency derivatives, commodity derivatives, debt segment, and securities lending and borrowing scheme. Further details on the various activities involved in “Central counterparty clearing” are discussed subsequently.
2. Non-guaranteed settlement services: NCL offers non-guaranteed settlement services for mutual fund platform, settlement of OTC transactions in corporate debt securities, offer for sale, and tender offer.
3. Compliance, Regulatory and supervisory activities: In addition to NCL’s own compliance with applicable laws and regulations, NCL also plays a regulatory and supervisory role in respect of conduct of business by clearing members. This includes obtaining and monitoring various kinds of reporting/disclosures, monitoring compliance with requirements placed upon clearing members, clearing member inspections, enforcement actions, submission of data and reports to other MIIs

and SEBI etc.

4. Membership: Processing new membership and surrender applications.
5. Services to other CCs: NCL offers technology and/or operational services to other clearing corporations, viz. outsourcing arrangement for providing services to AMC Repo Clearing Ltd. and providing services for business continuity arrangements to Indian Clearing Corporation Ltd. under Software as a Service model.

In the enumeration of activities above, “Central counterparty clearing” denotes whole range of activities involved in the life cycle of the transaction from trading till settlement. These activities include:

1. Collateral management: Collateral management activities include setting up eligibility criteria for various types of collateral, prudential limits on acceptance of collateral, and system and procedures for valuation of collateral. Collateral management operations encompass acceptance of various types of collateral, valuation and enhancement of margin limits, allocation of deposited collateral up to client level, release of collateral, and transfer of collateral between segments etc.
2. Risk management: Risk management activities primarily include setting up and calculation of risk parameters, real-time risk management, actions to be undertaken in case of margin shortfall etc.
3. Clearing: Clearing activities include facilitating confirmation/taking up of obligation by custodians/clearing members; determination of settlement obligations, providing various reports/statements to clearing members etc.
4. Settlement: Settlement activities involve effecting settlement of funds and securities by receipt and transfer in the bank and depository accounts maintained by clearing members; and taking actions in case of settlement shortages.

3.2 Classification of activities

According to the SEBI guidelines, CCs shall, *inter alia*, consider factors such as their risk profile, operations, organizational structure, financial resources, business practices, interconnectedness and interdependencies etc. to determine which of their activities are to be considered as critical. These factors have been discussed in preceding sections. The SEBI guidelines also require operations and services such as collateral management, risk management, clearing and settlement, etc. to be classified as critical; and also require the contractual obligations of CCs with CMs, Stock Exchanges, Depositories and other CCs, arising out of clearing and settlement of trades, to be necessarily classified as critical.

All activities that NCL is involved pertain to core clearing and settlement operations and incidental activities, and therefore all operations of NCL are considered to be critical.

4 Standard Operating Procedure for winding down

The standard operating procedure for winding down is specified separately for three broad scenarios: on account of voluntary winding down; involuntary winding down, whether due to default by CM (s) or due to other factors; and on account of regulatory actions.

4.1 Standard operating procedure for voluntary winding down

NCL shall follow the following procedure for voluntary winding down:

1. Approval of the governing board and shareholders will be obtained for voluntary winding down of critical operations and services.
2. Approval of SEBI will be sought for voluntary winding down of critical operations and services.
3. A notice for voluntary winding down will be issued by way of a circular.
4. NCL will offer to continue all operations for a notice period of 6 months. The last day of the notice period is denoted as “termination date”.
5. NCL shall not admit any new clearing members, as well as stop accepting new CMs under interoperable framework by way of change of designated CC from another CC to NCL.
6. In case NCL is proposing to introduce a new segment, the same will not be undertaken. Any systems or infrastructure development towards the new segment will be halted and any contracts with vendors will be sought to be terminated. Similarly, NCL will not undertake clearing for any new product if such product involves development of additional systems or technology/physical infrastructure. Clearing of new products that can be catered with the existing systems and infrastructure (e.g., introduction of a new underlying security in futures and options segment) may be undertaken, in order to minimize the impact on market participants.
7. NCL shall engage with other CCs to whom it is providing technology/operational services to take over such outsourced services undertaken for them. Such services, including systems and infrastructures will be transferred to CC at mutually agreed prices subject to necessary approvals. Such takeover of activities may also be done along with offer for employment of the personnel involved in performing the respective activities. If no such arrangement could be arrived at with the other CCs, NCL shall cease to provide services beyond the termination date.
8. In case of non-interoperable segments, the exchange may decide to discontinue the segment or engage with another CC to undertake clearing and settlement. NCL will provide all possible assistance to the exchange to avoid market disruption. Under such scenario, the new CC taking over the operations of NCL on as-is basis will minimize impact to the exchange and market participants. If the new CC agrees to take over NCL's operations, NCL will seek to transfer related systems and infrastructure along with offer for employment of personnel involved. NCL will advise its members to either obtain the membership of the new CC or close-out their open positions. Transfer of activities to the new CC can be done at any time even before the end of notice period, all CMs either obtain membership of new CC or close-out their open positions.
9. In case of interoperable segments, NCL will advise its clearing members to designate another clearing corporation under interoperability arrangement and transfer their positions and collateral to the interoperable clearing corporation, or alternatively close out their open positions, within the notice period.
10. At the end of the notice period, in case of non-interoperable segments:

- a. If the exchange does not engage alternate CC, all outstanding positions shall be deemed to be terminated at the daily settlement price of the “termination date”, i.e. the last day of the notice period.
- b. If transfer of all CMs to the new CC is still not possible (e.g., due to not all members obtaining membership of the new CC), then NCL will close-out open positions of such members in accordance with its operational procedures under its byelaws, rules and regulations and the applicable SEBI guidelines. The matched book of positions will be transferred to the new CC.

11. At the end of the notice period, in case of interoperable segments, if some CMs fail to transfer or close out their open positions, such positions shall be closed out in accordance with NCL's operational procedures under its byelaws, rules and regulations and the applicable SEBI guidelines.

4.2 Standard operating procedure for involuntary winding down due to default by CM (s) or due to other factors

The SEBI requirements as articulated in the circular requires CCs to provide critical services till a termination date, approved by SEBI. In case of winding down on account of losses, NCL will propose the termination dates for different services separately, based on the potential impact on the broader market. The operating procedure in this regard shall be as follows:

1. Approval of the governing board and shareholders will be obtained for involuntary winding down of critical operations and services.
2. Approval of SEBI will be sought for involuntary winding down of critical operations and services and termination dates will be obtained.
3. Winding down will be announced by way of a circular.
4. NCL shall not admit any new clearing members, as well as stop accepting new CMs under interoperable framework by way of change of designated CC from another CC to NCL.
5. NCL will not undertake any new product for clearing. However, new contracts in existing products may be undertaken for clearing, in order to prevent disorderly impact on the market.
6. NCL will provide the minimum notice of termination of outsourcing services offered to other CCs, in accordance with the agreement with them. NCL will offer, with necessary approvals including by SEBI, transfer of such services, including systems and infrastructures and offer for employment of personnel, at mutually agreed price.
7. NCL will seek to immediately terminate segments/services wherein there has not been any trading activity in the past 6 months.
8. NCL will seek to terminate segments/services where it has market share of less than 10%, within one month of announcement of winding down.
9. In case of other segments/services, where NCL's market share is more than 10%:
 - a. NCL will seek to terminate non-guaranteed settlement services within three months
 - b. NCL will seek to terminate segments with central counterparty clearing within 6 months.

10. In case of non-interoperable segments, the exchange may decide to discontinue the segment or engage with another CC to undertake clearing and settlement. NCL will provide all possible assistance to the exchange to avoid market disruption. Under such scenario, the new CC taking over the operations of NCL on as-is basis will minimize impact to the exchange and market participants. If the new CC agrees to take over NCL's operations, NCL will seek to transfer related systems and infrastructure along with employment of personnel involved. NCL will advise its members to either obtain the membership of the new CC or close-out their open positions. Transfer of activities to the new CC can be done at any time even before the end of notice period, all CMs either obtain membership of new CC or close-out their open positions.

11. In case of interoperable segments, NCL will advise its clearing members to designate another clearing corporation under interoperability arrangement and transfer their positions and collateral to the interoperable clearing corporation, or alternatively close out their open positions, within the notice period. Considering that NCL is under financial distress, it may find it difficult to obtain inter-CC capital to support the inter- CC collateral requirements. NCL will strive to work with members and interoperable CCs to carry out change in affiliation by CMs in such a way that inter-CC exposure does not increase. This can be achieved as follows: If all members are change affiliation at once, there may be no inter-CC exposure, if affiliation of multiple CMs is changed in a way that new CC receives an approximately matched book, the inter-CC exposure may not change substantially or based on positions, some CMs upon change in affiliation, may reduce the inter- CC exposure.

12. At the end of the notice period, in case of non-interoperable segments:

- If the exchange does not engage alternate CC, all outstanding positions shall be deemed to be terminated at the daily settlement price of the "termination date", i.e. the last day of the notice period.
- If transfer of all CMs to the new CC is still not possible (e.g., due to not all members obtaining membership of the new CC), then NCL will close-out open positions of such members in accordance with its operational procedures under its byelaws, rules and regulations and the applicable SEBI guidelines. The matched book of positions will be transferred to the new CC.

13. At the end of the notice period, in case of interoperable segments, if some CMs fail to transfer or close out their open positions, such positions shall be deemed to be closed out on the termination date. This might result in an unmatched book at the interoperable CC, which may be dealt with under the provisions of the interoperability agreement.

4.3 Winding down on account of regulatory action

The SEBI circular on framework for orderly winding down of critical operations and services clearing corporations specifies that under the scenario of winding down on account of regulatory action, SEBI will issue appropriate directions on a case-to-case basis.

In the event such a scenario:

1. Governing board and shareholders will be intimated regarding winding down on account of regulatory actions.
2. Winding down will be announced by way of a circular.
3. NCL will follow the directions issued by SEBI for orderly winding down.

5. Financial resources for winding down

The minimum regulatory period of 6 months is considered to be adequate for exchanges/members to establish alternative arrangements. CCs are required to maintain capital to the extent of 6 months of operating expenses, which is also insulated from utilization in default waterfall. In accordance with the SEBI circular, this capital will be utilized during winding down period.

6. Return of Assets

In accordance with the Clause 5 of the SEBI circular on the framework for orderly winding down of CCs, NCL shall be permitted to distribute its assets subject to conditions as laid down in its framework, guidelines issued by SEBI from time to time, or any other direction issued by SEBI or any other statutory authority

7. Applicability of relevant rules, regulations, byelaws and circulars thereunder

The provisions of SECC Regulations, 2018 and various circulars and guidelines issued thereunder by SEBI, as well as rules, regulations and byelaws of NCL and circulars issued thereunder shall continue to apply during the entire period of winding down of critical operations and services.

8. Details of designated employees responsible for development, review, and ongoing monitoring of winding down process

The employees at level Manager and above for Vertical 1, Vertical 2, Secretarial, Legal , HRD and Accounts department shall be designated employees or staff members who shall be retained and responsible for development, review, and ongoing monitoring etc. of the critical operations and services, once the process of orderly winding down of critical operations and services is initiated. Further, required employee strength at level Manager and above for Vertical 1, Vertical 2, Secretarial, Legal , HRD and Accounts department are placed as Annexure. Further, the roles and responsibilities for the employees shall be as per approved Goal Plan for the employee. The assets defined as Critical assets by SEBI along with the details of Members, Legal documents and financials shall be retained and continued for orderly winding down of critical operations and services.

9. Oversight and review of the winding down policy

The Regulatory Oversight Committee (ROC) of the NCL shall oversee the implementation of steps or processes involved in orderly winding down of critical operations and services. This winding down framework will be reviewed at least on an annual basis.

Annexure 1

Department/Vertical	Head Counts
Vertical 1	141
Vertical 2	48
Finance & Accounts	5
Human Resources	4
Legal	3
Secretarial & Corp. Compliance	2

