

Curbing Speculation vs. Market Participation: A Study of SEBI's 2024 Derivatives Measures

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Abstract

The derivative market has become a cornerstone of India's financial ecosystem, complementing the traditional stock market by enabling risk management, price discovery, and liquidity enhancement. However, with the rapid growth of this segment, concerns over speculative activities have prompted regulatory intervention. On October 1, 2024, the Securities and Exchange Board of India (SEBI) introduced significant reforms aimed at curbing speculation, protecting retail investors, and fostering market stability. While these changes are intended to address market imbalances, they have sparked debate over their potential to unintentionally restrict retail investor participation and impede market inclusivity. This paper critically evaluates SEBI's regulatory reforms, analyzing their impact on market dynamics, retail investor engagement, and overall economic objectives. It draws comparisons with international regulatory frameworks, highlighting areas where the reforms succeed and where they may require recalibration. By exploring the balance between investor protection and market accessibility, this paper underscores the need for a more nuanced approach to derivative market regulation. It concludes with practical recommendations to create a framework that fosters sustainable growth, mitigates speculative risks, and ensures the long-term health of India's financial markets.

Keywords: Derivative Markets, SEBI Regulations, Retail Investor, Participation Speculation, Control Market Stability

INTRODUCTION

The stock market serves as the backbone of any free-market economy, providing businesses with access to capital in exchange for stakes in the businesses conferring ownership to the extent of investment. In India, the stock market has been instrumental in driving economic growth, fostering wealth creation, and promoting financial inclusion. Since the liberalization, privatization, and globalization (LPG) reforms of the 1990s, the Indian stock market has witnessed remarkable growth, attracting both domestic and foreign investments leading to a significant contribution in the country's economic progress.

Alongside the traditional cash market, the derivative market has emerged as a vital segment of the financial ecosystem. This market facilitates hedging, aids in efficient price discovery, and to some extent provides an avenue for speculative activities, however, also offering participants tools to manage risks and enhance returns. Derivatives have played an increasingly important role in boosting market liquidity and stabilizing the broader financial system [1].

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On October 1, 2024, SEBI passed a Circular [2] which sought to introduce significant regulatory changes to the derivative market. These regulations, aimed at safeguarding retail investors and ensuring market stability, by including measures such as

increased lot sizes and higher entry barriers for derivative trading. However, prior to the passage of the Circular, SEBI issued a Consultation Paper dated 30th July 2024 (CP 2024) [3] in order to obtain inputs on the contents of the Circular. CP 2024 provides an insightful exposition on the reforms brought in by the Circular. Subsequently, these reforms sparked widespread debate regarding unintended consequences, apart from their envisioned aim to address concerns surrounding investor protection and speculative losses. Retail investors, who form a substantial part of the derivative market, are particularly affected, raising questions about whether these measures restrict participation rather than fostering inclusivity.

This paper thoroughly examines SEBI's recent regulatory reforms, analyzing their direct and indirect effects on the derivative market. It explores the broader implications of these changes, drawing parallels to similar regulations implemented in other countries, and assesses the challenges they pose to retail investors and market dynamics. The paper also offers practical recommendations for creating a more balanced framework that protects investors without undermining their ability to participate in the market. Through this study, the paper aims to contribute to a deeper understanding of the derivative market's evolution and the need for thoughtful regulation to ensure its long-term growth and stability.

Understanding Derivative Market

A derivative is a financial instrument whose value is derived from an underlying asset or group of assets, such as stocks, bonds, commodities, currencies, or interest rates [4]. Derivatives enable participants to speculate on price movements, hedge against risks, or make strategic investments without owning the underlying asset.

To understand the evolution of the derivatives market, it is essential to begin with Forward Contracts, which marked the inception of derivative trading [5]. A Forward Contract [6] is a customized agreement between two parties to buy or sell an asset at a predetermined price on a specified future date. These contracts are traded over-the-counter (OTC) and are highly flexible, allowing the terms to be tailored to meet the specific needs of the parties involved. However, this flexibility also brings significant drawbacks. The absence of standardization and central clearance in Forward Contracts exposes parties to high counterparty risks, as there is no regulatory oversight to ensure the performance of the contract. This lack of regulation and transparency made Forward Contracts inefficient and risky, particularly in cases of default by either party.

To address these shortcomings, the futures market was developed, introducing standardized contracts traded on regulated exchanges. Futures Contracts retain the core principle of Forward Contracts; obligating the buyer to purchase, and the seller to sell, an asset at a predetermined price on a specified future date, but with enhanced safeguards. The standardization of terms, centralized clearance mechanisms, and regulatory oversight in the futures market significantly reduced counterparty risks and improved market transparency. These features made Futures Contracts more reliable and accessible, allowing for greater participation and liquidity in the derivatives market.

Options Contracts [7] have played a crucial role in the evolution of the derivatives market by introducing a level of flexibility that was absent in traditional forward and futures contracts. Unlike futures contracts, which create an obligation for both parties to execute the trade on the agreed-upon date, options contracts provide the buyer with the right but not the obligation to buy or sell an asset at a predetermined price before a specific expiration date.

There are two types of options: *call options* and *put options*. A call option gives the buyer the right to purchase an asset at a fixed price within a specified period, which can be beneficial when the market price of the asset rises. On the other hand, a put option grants the buyer the right to sell an asset at a fixed price, which is useful when the asset's market value declines. Because options allow investors to control assets without immediately purchasing or selling them, they serve multiple purposes, including hedging against risks, making strategic investment decisions, and speculating on market

movements [8].

By allowing traders to participate in the market with limited downside risk while maintaining the potential for significant gains, options contracts have become a valuable tool for investors, risk managers, and institutions looking to optimize their trading strategies.

The development of the futures and options (F&O) market addressed the limitations of forward contracts while providing participants with versatile tools for managing risks and capitalizing on market opportunities. One of the key functions of derivatives in this evolved market is price discovery, which uses current market information to determine the future price of an asset. This mechanism enhances market efficiency and helps participants make informed decisions.

SEBI has played a significant role in regulating the Indian derivatives market, ensuring transparency and safeguarding participants. Over the years, retail investors have contributed significantly to the growth of the F&O segment, adding vibrancy and liquidity to the market. However, SEBI's recent regulatory changes, particularly those affecting futures and options trading, have introduced challenges for small-scale investors, particularly those with limited capital.

Evolution of the Derivative Market

Before the advent of modern derivative instruments, India relied on the Badla system, a unique trading mechanism that allowed traders to carry forward their positions by paying a fee. While this system provided trading flexibility and leverage, it also attracted criticism for encouraging excessive speculation and market instability. Eventually, the Badla system was banned, paving the way for a more structured and regulated derivatives market.

The formal introduction of derivatives trading in India began on June 12, 2000, with the launch of Index Futures on the National Stock Exchange (NSE) [9]. These contracts, based on the NIFTY 50 Index, marked the beginning of a transparent and standardized derivatives market. A year later, in June 2001, index options on the NIFTY 50 [10] were introduced, further broadening the scope of derivatives trading. Over time, the market expanded to accommodate a wide range of instruments, including stock futures, stock options, and other derivatives, catering to the needs of hedgers, speculators, and arbitrageurs [11].

The journey toward establishing a formal derivatives market was shaped by significant regulatory advancements. In December 1997, the L.C. Gupta Committee recommended introducing financial derivatives as risk management tools. The committee highlighted the need for a regulated framework to ensure market stability and investor protection. However, derivatives trading could only commence after the Securities Contracts (Regulation) Act, of 1956 was amended to formally recognize derivatives as securities. The lack of a proper regulatory framework prior to these amendments delayed the development of the derivatives market in India.

Interestingly, India's history with derivatives dates back much further. Commodity futures trading existed in the country as early as 1875. However, during the 1960s and 1970s, futures trading in many commodities was banned, and forward trading was prohibited in the 1960s due to concerns over speculative activity. The reintroduction of financial derivatives in 2000 [12] marked a turning point, establishing India as a significant player in the global derivatives market.

SEBI Introducing New Changes

Before delving into the proposed changes introduced by SEBI [13], it is essential to understand why these changes are being considered in the first place. In CP 2024, SEBI acknowledged the astonishing growth in the derivatives market. It highlighted that while derivatives products offer several benefits such as aiding price discovery, improving liquidity, and providing hedging opportunities the segment has also led to significant losses for retail investors [14]. SEBI observed that in FY 2023-24,

approximately 92.5 lakh unique individuals and proprietorship firms traded in the Index Derivatives segment on the NSE, but only about 14.22 lakh of these investors turned a profit. The overall loss in this segment was a staggering ₹51,689 crore [15].

Further, SEBI's older reports also reveal that 89% of individual traders in the equity F&O segment incurred losses during FY 2021-22, with an average loss of ₹1.1 lakh per trader [16]. This data underscores the risks retail investors face in derivatives trading. SEBI has concluded that despite the advantages of derivative products the current structure of this segment, especially with the proliferation of speculative activities, has not been conducive for small retail investors.

According to SEBI [17], three key factors contribute to the volatility and investor losses in this market: (1) the increase in the number of weekly derivative products; (2) the surge in overall trading turnover and; (3) trader behaviour on expiry days.

Increase in the Number of Weekly Derivative Products

Typically, the minimum timeline for expiry of Equity Derivatives Contracts is of one month. However, Index Options (benchmark, sectoral, etc.) is an exception to this norm, where the contract termination takes place on a weekly basis. In 2016, the NSE introduced weekly options contracts on sectoral indices, followed by weekly contracts on benchmark indices [18] in 2019. Initially, all such contracts expired on a single designated day of the week. However, in 2023, the scenario changed when BSE reintroduced weekly index derivatives contracts in May 2023. In view of maintaining the liquidity levels, the contemporary Stock Exchanges (NSE & BSE) scheduled the expiry dates of their respective Weekly Contracts on different days of the week by providing scope for a single investment option at particular point of time.

For instance, the current expiry schedule spans across multiple days for indices like MIDCAP, FIN NIFTY, BANK NIFTY, NIFTY, and SENSEX & BANKEX. SEBI's analysis highlights that trading activity becomes hyperactive on expiry days, particularly during the last trading hour. This concentrated activity on expiry days, driven by speculative behaviour, has contributed significantly to market volatility and investor losses.

Increase in Overall Trading Turnover

The derivatives market in India sky-rocketed showcasing growth which surpassed even the cash market. As per reports, due to incredible advancements in technology & digital access, India contributes for 30% to 50% of global exchange-traded derivatives trades [19]. The post-COVID era witnessed a surge in retail investor participation, with the total number of demat accounts ramping up to 15.8 crore by May 2024, amongst which 12.2 crore were opened after April 2020 [20].

The launch of weekly derivatives contracts on benchmark indices in 2019 marked paradigm shift in trading patterns, with retail investors gravitating toward index options. Between FY 2018 and FY 2024, SEBI noted a dramatic rise in the annual turnover of index options (premium), growing from ₹4.5 lakh crore to ₹138 lakh crore [21]. This sharp increase in trading volume has heightened the speculative nature of the market, particularly around weekly expiries.

Behaviour of Traders on Expiry Days

SEBI's examination of data from June 2023 to July 2024 reveals that market volatility spikes on expiry days, particularly during the last half hour of trading [22]. For instance, NIFTY was found to be most volatile on Thursdays, which are popular weekly expiry days, compared to non-expiry days. Intraday price variations for indices like NIFTY and BANK NIFTY further show that the last 30 minutes of trading on expiry days are significantly more volatile than the same period on other trading days.

Additionally, SEBI noted that during July 2024, the notional turnover on expiry days accounted for

approximately 96% of the total turnover for SENSEX weekly contracts and 64% for NIFTY contracts. This suggests that the majority of trading activity is concentrated on expiry days, with little to no significant liquidity observed during the days leading up to expiry. Such patterns indicate that many traders approach these markets with a speculative mindset, attempting to capitalize on last-minute price movements rather than using derivatives for wealth creation or hedging purposes.

The *Six Measures* adopted in the Circular are envisaged to redress heightened speculative trading volumes in Index derivatives on expiry dates. Apart from capping speculative trading, the measures seek to cure poor profitability outcomes for individual investors. Ultimately, the measures are an effort to install a framework capable of enhancing investor protection and market stability.

PROPOSED CHANGES

The *Six Measures* that SEBI has given to protect the Individual investor and maintain the stability of the Stock Market [23].

Upfront Collection of the Option Premium from Option Buyers

SEBI has proposed the upfront collection of premiums from option buyers before executing a trade. Under the existing framework, upfront collection of margins was already mandatory for futures positions (both long and short) and for short options positions. However, there was no explicit stipulation for the upfront collection of premiums from option buyers for long positions; buyers had to pay the premium only upon execution of the trade. The new proposal seeks to address this gap by mandating that option buyers pay the premium upfront to their brokers. SEBI attributes this change to the unique characteristics of options. Options are priced in a non-linear manner and involve significant implicit leverage. They are also time-sensitive contracts, with prices that can appreciate or depreciate rapidly. To mitigate the risks associated with undue intraday leverage at the end-client level and to prevent clients from taking positions beyond their collateral, SEBI has deemed it necessary to enforce upfront premium collection.

This change aligns with existing practices followed by many large and well-established brokers, who already collect premiums upfront. As a result, the implementation of this proposal is unlikely to significantly disrupt the current trading system.

Intraday monitoring of position limits

As per the existing practices, the market institutions (Stock Exchanges, Clearing Houses, etc) have time to time monitored the position limits as specified by SEBI for the index derivative contract at the end of the day. Particularly, amidst the large volumes of trading on expiry day, there is a possibility of unidentified intraday positions beyond permissible limits during the course of the day. To address the aforementioned risk of position creation beyond permissible limits [24], it has been decided by SEBI that existing position limits for index derivatives shall henceforth also be monitored intra-day by exchanges [25]. Therefore, Stock Exchanges are purported to consider a minimum of 4 position snapshots during the day. The snapshots would be randomly selected during pre-decided time windows [26].

This change is related to the market institutions so it is not again going to impact the traders or the market directly.

Increase in tail risk coverage on the day of options expiry

Currently, there is no mechanism to increase margins on options contracts specifically during the expiry period. However, on options expiry day, speculative trading and volatility significantly increase, amplifying the risk of extreme market events, also known as tail risk. To address this issue, SEBI has proposed an additional Extreme Loss Margin (ELM) of 2% to be levied on all short options positions expiring that day [27]. This applies to both open short positions at the start of the day and new positions

initiated during the day.

Removal of calendar spread benefit on expiry day

A calendar spread [28] is a trading strategy involving simultaneous positions in options or futures contracts on the same underlying asset but with different expiry dates. For example, suppose a trader buys a futures contract expiring on March 31st at ₹1,000 and sells another futures contract expiring on April 30th at ₹1,050. Since the two contracts are closely related and their prices tend to move in correlation, the risk of holding both positions together are lower than holding them individually. As a result, exchanges usually allow a margin benefit, meaning the trader is required to deposit less margin than they would for two separate, unrelated positions. This margin benefit is referred to as a calendar spread.

However, on expiry day, the value of the expiring contract can behave very differently from contracts with later expiry dates due to basis risk i.e. the divergence [29] between the prices of the two contracts. For instance, if the contract expiring on March 31st suddenly drops to ₹950 due to heightened expiry-day volatility, while the April 30th contract remains at ₹1,050, the offsetting nature of the positions no longer applies effectively.

To address this issue, SEBI has decided to remove calendar spread margin benefits for contracts expiring on the expiry day. This ensures that traders hold sufficient margins to cover the increased risk of price divergence. While the margin benefit [30] is revoked for expiry-day contracts, it continues to apply to positions involving later expiries, such as between the April 30th and May 31st contracts in this example. This change enhances risk management by aligning margins with the actual risk exposure during periods of heightened volatility and trading volume.

Increase in Contract size for index derivatives

The minimum contract size for derivative contracts, which has been set between ₹5 lakhs and ₹10 lakhs since 2015, is being revised due to significant market growth over the past nine years. During this period, benchmark indices have nearly tripled in value. As per SEBI the current framework, while functional, does not adequately address the heightened risks and implicit leverage inherent in derivatives trading. To align with these market developments and ensure better risk management, SEBI has proposed increasing the minimum contract size for index derivatives. In this revision, the minimum value of derivative contracts at the time of their introduction will be set between ₹15 lakhs and ₹20 lakhs, reflecting the broader growth in market parameters and mitigating the risks associated with these highly leveraged financial products.

Rationalization of Weekly Index derivatives products

Herein SEBI has decided to rationalize the offering of weekly index derivatives to enhance investor protection and promote market stability. Currently, weekly expiry contracts are available on multiple indices across exchanges, resulting in expiry on all five trading days of the week. This practice has led to speculative trading, with a significant portion of trading volume concentrated on expiry days, driven by low option premiums and short holding periods, often averaging just minutes.

The hyperactive trading on expiry days has been linked to increased market volatility, particularly during closing hours, and poses risks to market stability, especially in the event of a black swan event. Additionally, data reveals that up to 80-90% of the notional turnover in weekly options occurs during expiry weeks, with limited benefits for sustained capital formation and poor profitability outcomes for retail investors. To address these concerns, SEBI has mandated that exchanges offer weekly options contracts only on a single benchmark index (one contract per stock exchange or one contract expiry per exchange per week), thereby reducing the frequency of expiries and mitigating the associated risks.

Analyzing the global precedent: South Korea

Securities Markets across the world hinge on the same economic principles. Thus, it is important to

overview the effect of similar measures implemented in multiple nations. Amongst these nations South Korea resembles greatly with Indian Stock Markets. Thus, what follows is a thorough analysis of the effect of similar measures in the South Korea.

The case study of South Korea has great importance here because of the new rules that are being implemented in the Indian Stock Market. Some of these rules were also introduced in South Korea which failed to give the expected result as contemplated by the Korean authorities.

During the early 1990s, the South Korean government introduced measures to make F&O trading more attractive. To encourage active participation and boost turnover, they abolished capital gains taxes on F&O profits. Additionally, to make options trading more accessible, the government set the lot size for options contracts at one-fifth of those for futures contracts.

However, in 2011, the Financial Services Commission (FSC) of South Korea implemented stricter regulations, resembling the measures recently proposed by SEBI in India. These regulations aimed to protect retail investors but had severe unforeseen ramification for the F&O market. The new rules introduced high entry barriers, requiring traders to maintain a minimum capital of 15 million won (approximately \$8,000–\$10,000) to trade in the F&O segment. Lot sizes for contracts were increased, limiting small traders' participation. Additionally, the FSC mandated 20 hours of training and three mock trading sessions before market entry. Although the intent was to prevent retail investors from incurring heavy losses, these changes caused severe disruptions in the market.

South Korea's stock exchange, once a global leader in F&O trading, fell dramatically in rankings. It slid from the top position in 2010 to 5th place by 2012 and dropped out of the top 10 entirely by 2013 [31]. Turnover in the F&O segment, which stood at 2 trillion won in 2010, plummeted to just 110 billion won by 2014. The number of traded contracts fell by 70%, with only 430 million contracts being traded compared to the earlier global growth rate of 15% annually [32]. The stricter regulations also drove away institutional players, such as Qualified Institutional Buyers (QIBs) and Foreign Institutional Investors (FIIs). These players migrated to alternative markets like Japan and China, which had more favorable regulatory conditions. The exodus of institutional participants, combined with declining retail involvement, drastically reduced liquidity and market growth.

Retail investors, who were the primary focus of the regulations, expressed frustration, claiming that the FSC's measures not only failed to protect them but also led to significant market-wide losses. By 2013, King Yong Beom, then Director of the FSC, admitted that some of the regulations were excessively harsh and counterproductive [33]. Acknowledging these failures, the FSC announced deregulations in 2019 to revive the market. Key changes included reducing the minimum capital requirement by 60–70%, cutting mandatory training hours from 20 to just 1 hour, and eliminating the additional 10% margin requirement for institutional and algorithmic traders. Additionally, new derivative products were introduced under FSC oversight.

Despite these corrective measures which took place at a late time, the damage to the market was significant. By 2018, the proportion of institutional investors had fallen from 48.7% to 36.1%, while retail investor participation declined from 25.6% to 13.5% [34]. These figures highlight how the FSC's overregulation negatively impacted the entire market, undermining its growth and liquidity.

The South Korean experience serves as a cautionary tale for overregulation in financial markets. It underscores the importance of balancing investor protection with fostering a healthy, inclusive trading environment. As India contemplates similar regulatory measures through SEBI's circular, it is crucial to assess whether these steps will genuinely address retail investor losses or inadvertently stifle the growth potential of the Indian F&O market.

Analysis

If we analyze the six changes implemented by SEBI, they can be broadly categorized into two types.

The first category includes measures aimed at curbing heightened activity in derivative trading on expiry day, such as *intraday monitoring of position limits*, *increase in tail risk coverage*, *removal of calendar spread benefits on expiry day*, and *rationalization of weekly contracts*. These changes are designed to address the surge in speculative trading and volatility typically observed on expiry days, ensuring a more stable and orderly market.

The second category as per SEBI focuses on ensuring continued suitability and maintaining basic risk hygiene. This includes measures like the *upfront collection of premiums* and the *increase in contract size*. These adjustments aim to reinforce risk management practices, minimize excessive leverage, and promote disciplined trading behavior among participants.

The changes regarding the upfront collection of premiums and intraday monitoring of position limits are unlikely to significantly impact the market. This is because these changes primarily target compliance aspects of market institutions rather than directly influencing traders' activities. Regarding the upfront collection of premiums, this practice has already been implemented by most established brokers. SEBI's move essentially formalizes the existing practice, ensuring uniform compliance across the board. By mandating that option buyers pay the premium upfront, SEBI aims to mitigate risks associated with high leverage and fast-paced price movements in options contracts. This measure enhances transparency and accountability but doesn't introduce a major shift for the majority of market participants who were already adhering to this standard.

Similarly, the requirement for intraday monitoring of position limits focuses on strengthening the oversight capabilities of market institutions like stock exchanges and clearinghouses. By introducing random intraday snapshots to monitor positions, SEBI seeks to address the risks of excessive position creation, particularly during high-volume periods like expiry days. However, this change is operational in nature and does not directly alter the trading behavior of individual participants.

Discussing the increase in tail risk coverage and the removal of calendar spread benefits, it is evident that these changes can initially impose a significant impact on traders by increasing the cost of trading on expiry day compared to other days. At first glance, this move may seem like an additional burden on traders. However, if we consider the primary purpose of derivative products—to serve as instruments for hedging rather than speculative trading—this change becomes more justifiable.

Mathematically, if other factors affecting the premium or margin of a contract remain constant, options premiums tend to decrease sharply as expiry approaches. This reduced premium makes F&O trading on expiry day particularly appealing to some traders as an inexpensive and speculative "lottery ticket." Such trading often involves high-risk activities with low probabilities of success. It is challenging to attribute any significant benefit to the overall securities market ecosystem or capital formation from this concentrated, speculative hyperactivity on expiry day [35]. By increasing margins and removing calendar spread benefits on expiry days, SEBI aims to deter individual traders with a gambling mindset from engaging in speculative trading. This, in turn, is expected to reduce volatility on expiry day. Notably, these measures are confined to trades occurring on the expiry day itself, limiting their impact on longer-term positions.

For genuine traders, however, the implications of these changes could be more nuanced. Traders who enter contracts well before the expiry date for hedging purposes may now feel compelled to either square off their positions before expiry approaches or maintain additional margins as the expiry day nears. This effectively shortens the trading timeline for such participants, as they must choose between incurring higher costs or exiting their positions prematurely.

While these measures may create short-term challenges for traders, they ultimately aim to enhance the market's overall stability and integrity. By curbing speculative trading during periods of heightened volatility, SEBI reinforces its commitment to risk management and ensures that derivatives trading

aligns more closely with its intended purpose—hedging against risk rather than speculative profiteering.

Now after analyzing the other things, it is important to discuss the aspect of changes in the Weekly Expiry and Increase in the Contract Size since changes in these two aspects can have a profound impact on the stock market volatility.

Changes made to the Contract Size

The decision to increase the minimum contract size for index derivatives from ₹5 lakh to ₹15 lakh–₹20 lakh is a significant development that will have a profound impact on F&O traders, particularly small retail investors. Many of these investors are in the early stages of trading, experimenting with limited capital to understand the nuances of options trading and evaluate whether consistent profitability is achievable. By tripling the minimum contract size, SEBI has effectively barred a substantial segment of retail investors from participating in the derivatives market. This includes both genuine traders and speculators who previously contributed to the market's vibrancy. Retail participation in India's derivatives market has surged, with the number of active derivatives traders increasing from under half a million in 2019 to over 4 million now, an eightfold increase [36]. Now this substantial increase in contract size may create a barrier for these investors which are present in large numbers, potentially leading them to seek alternative investment avenues that are less regulated and require lower capital but come with higher risks.

For instance, following SEBI's tightening of derivatives trading rules, many retail traders have started exploring alternative avenues like cryptocurrencies, forex trading via unregistered brokers, and unregulated peer-to-peer lending platforms—markets that fall outside SEBI's regulatory framework. A 2023 report by Reuters highlighted how regulatory measures can lead to a surge in retail participation in offshore forex platforms and other options, exposing investors to heightened risks such as fraud, lack of grievance redressal mechanisms, and regulatory crackdowns [37].

This measure disproportionately affects small retail investors who, despite limited capital, sought to learn and engage with the market. By restricting their entry, SEBI risks pushing them toward unregulated investment activities, defeating the stated purpose of investor protection. A more pragmatic approach would have been to address the root cause: the eligibility criteria for options trading. Presently, participation is determined by capital availability rather than the trader's knowledge or understanding of the market. This approach unfairly classifies investors based on wealth rather than education or expertise, creating an unreasonable barrier for capable yet undercapitalized traders.

SEBI's strategy seems to lean toward regulating the capital market with a quasi-socialist mindset, attempting to shield retail investors from potential losses rather than fostering their participation with adequate safeguards. The speculative nature of the derivatives market is an inherent characteristic, and SEBI's role should be to prevent fraudulent practices and ensure fair play, rather than outright limiting participation. Losses in derivatives trading are a natural consequence of market dynamics, where one party's gain is another's loss. Therefore, restricting small investors from participating undermines the fundamental principles of a free market.

Instead of increasing the minimum contract size, SEBI should focus on creating an environment that encourages retail participation while protecting them from unfair practices. Education and awareness initiatives would serve as better tools for investor protection. The current move raises concerns that the derivatives market is being turned into a playground for the elite, where wealth—not market knowledge—determines access. Ironically, even wealthy investors can lack the expertise to navigate the market and face losses, disproving the assumption that higher capital correlates with better risk management.

Historically, the decision to stipulate a minimum contract size was first introduced in the 14th Report of the Standing Committee on Finance (1998-99), with a threshold of ₹2 lakh to protect small investors from speculative risks [38]. However, two decades later, the relevance of such restrictions deserves

reevaluation. During that era, alternative mechanisms like Badla, ALBM, and BLESS were available for long-term market participation. Today, with rolling settlements in place, derivatives are the primary tool for hedging and risk management. By setting a ₹15 lakh minimum contract size, SEBI deters many investors whose portfolios may not align with this requirement, limiting their ability to use derivatives for efficient risk management.

Derivative markets serve an essential economic purpose, particularly in price discovery, which relies on the collective perceptions of a diverse group of participants. By excluding a large section of retail investors, SEBI risks reducing the diversity of market views, potentially impairing the price discovery mechanism. Furthermore, the higher contract size will lead to increased margin and premium requirements, resulting in larger losses for retail investors, particularly option buyers, who are most affected by this change. Earlier, the cost of entry and learning was lower, and even in cases of losses, the financial impact was manageable. Now, higher entry costs and increased risks could exacerbate losses for new traders.

An unintended consequence of this regulation could be a shift of retail investors from index derivatives to stock options, where similar minimum contract size requirements do not apply. This shift could increase liquidity in the stock options market but might also introduce new challenges. Additionally, denying retail investors entry into the derivatives market might push them toward less regulated or entirely unregulated avenues, which poses a greater risk to their financial safety. This indicates that SEBI might be more concerned with protecting its reputation than genuinely safeguarding investors. By restricting access, SEBI aims to reduce visible losses among retail traders in the derivatives segment, but this approach may inadvertently harm the very group it seeks to protect.

Changes made to Weekly Contract

As discussed earlier, the availability of weekly contracts with expiries on different days of the week has allowed traders to engage in expiry-day trading on multiple contracts throughout the week, fostering speculative behaviour. Under SEBI's new proposal, this practice will end, with only one weekly contract per exchange. Based on the data shared by SEBI regarding trader participation on expiry days, this move appears beneficial for all types of traders. By reducing the frequency of weekly expiries, the gambling mindset that has gradually developed among traders is expected to decline, curbing speculative behaviour.

While this measure looks like a commendable step by SEBI, a closer inspection reveals that this proposal essentially rolls back a decision that SEBI itself had introduced earlier. SEBI had initially permitted the introduction of weekly contracts across various indices with staggered expiries. Ideally, SEBI should have conducted a more thorough analysis at that time to foresee the potential outcomes and mandated a single expiry day per week from the outset.

If we analyze historical data from the last 5–6 years, we can observe how the market reacted to the introduction of multiple weekly expiries. For instance, the NSE introduced weekly options for Bank Nifty on May 27, 2016, [39] when the market turnover (premium) was relatively constant at around ₹27,000–₹30,000 crore. By 2017, this number nearly doubled. Similarly, when Nifty weekly options were introduced on February 11, 2019 [40], turnover began rising sharply again. By March 2020, turnover had increased by 7–8 times, despite only two weekly contracts being available. This surge occurred even before external factors like the COVID-19 pandemic and the rise of financial influencers promoting F&O trading.

In January 2021, the introduction of Fin Nifty options further increased turnover by 50% within a month, demonstrating that the initial surge in trading activity was primarily driven by weekly expiries [41]. A more recent example is the relaunch of SENSEX and BANKEX options by BSE in May 2023, which generated a turnover of ₹17,345 crore (₹17,316 crore in options and ₹29 crore in futures) [42] shortly after their introduction. This suggests that the speculative behavior and habit of trading weekly

options were gradually cultivated by the structure of the market itself.

However, SEBI's consultation paper only provides data on notional turnover near expiry for weekly contracts in July 2024, without offering a comparative analysis of trader behavior during the expiry of monthly contracts. This raises an important question: Is trader behavior on expiry day fundamentally different between weekly and monthly contracts? Is there truly a need to curb activities specific to weekly contracts without addressing similar behaviors in monthly expiries?

Another implication of this move could be a significant increase in the trading volume of the new single weekly contract per exchange or a shift toward higher volumes in monthly contracts—or both. As discussed earlier, the introduction of weekly contracts led to a surge in the number of investors participating in the market. With the removal of multiple weekly expiries, these investors are likely to redirect their trading activity toward the remaining available weekly contracts or shift focus to monthly expiries. A similar pattern was observed in the past when regulatory interventions altered contract structures. For instance, the introduction of Bank Nifty weekly options in 2016 led to a substantial rise in turnover within a year [43], and the launch of Fin Nifty options in 2021 resulted in a 50% increase in trading volumes within a month [44]. These trends suggest that traders tend to concentrate activity around available expiry days, meaning SEBI's new mandate may not eliminate speculative behavior but rather shift its focus to the remaining contracts.

A more pragmatic approach that SEBI could have taken would be to implement the other five measures first (as proposed in the circular) and evaluate their impact on speculative activity before phasing out the existing weekly contracts. Given SEBI's track record of implementing reforms in a phased manner, this direct rollback seems to deviate from its usual approach. By prematurely discontinuing weekly contracts, which have contributed substantial liquidity to the market, SEBI risks unintended consequences that could have been mitigated through a more measured strategy. Alternatively, SEBI could have mandated a common expiry day across exchanges for all weekly contracts instead of eliminating current expiries and restricting them entirely to just one contract per exchange. This could have helped distribute speculative activity more evenly across a single day, potentially reducing extreme volatility by providing traders with more hedging options on the expiry day itself.

The advantage to the BSE over the NSE: Blessing in disguise

SEBI's proposed changes to rationalize weekly index derivatives contracts could unintentionally give BSE a competitive edge over NSE in the derivatives market. Historically, NSE has dominated this space, accounting for nearly 80% of trading volumes, thanks to its liquidity, robust infrastructure, and strategic innovations. However, the new rule restricting exchanges to one derivative contract expiry per week might alter this dynamic. Currently, NSE offers weekly expiry contracts for its two flagship indices NIFTY and Bank NIFTY both of which are highly traded and generate significant transaction revenues. In fact, equity options make up four-fifths of NSE's transaction revenue. If SEBI enforces the "one contract expiry per exchange per week" rule, NSE would be forced to prioritize one contract, leaving the other sidelined or shifting to monthly expiries. This could fragment its trading volumes and impact its revenue, as traders might migrate to alternative contracts.

On the other hand, BSE, with its nascent derivatives offerings, stands to gain. Over the years, BSE has struggled to capture a significant share of the derivatives market, commanding only about 20% of trading volumes. Despite several initiatives such as keeping lot sizes small, lowering transaction costs, and introducing differentiated expiry days BSE has remained in NSE's shadow. However, SEBI's proposal could change that.

BSE's derivatives contracts, particularly SENSEX and BANKEX, would now have a unique opportunity to attract traders looking for weekly expiry options. If NSE is restricted to offering only one weekly expiry, the trading volume and interest from displaced contracts might shift to BSE's derivatives segment. This would help BSE gain traction, potentially increasing its market share

significantly.

Additionally, SEBI's rules might indirectly enhance BSE's attractiveness by levelling the playing field in a market long dominated by NSE. As one expert remarked, this could give BSE a chance to capture as much as 50% of the derivatives market an unprecedented leap for the exchange [45]. While the proposed changes are aimed at curbing speculative trading and protecting retail investors, they might inadvertently become a game-changer for BSE, allowing it to narrow the gap with NSE in the derivatives segment. Whether this prediction materializes depends on how the final rules are implemented and how exchanges and traders adapt to the new landscape.

Suggestion

The foremost plausible solution that SEBI can opt for is to start utilizing its funds for educating the Trader/Investor. It must be borne in mind that lack of fund is not an issue since SEBI has ample fund for this purpose.

Investor Protection Education Fund

The Investor Education and Protection Fund (IEPF) was established under Section 125 of the Companies Act, 2013, with funds deposited through contributions by the central government, institutions, and earnings from various unpaid and unclaimed amounts left for seven years, such as unpaid dividends, application money for securities, and matured deposits and debentures. The primary objective of this fund, as outlined in clause 3(b) of Section 125 [46], is to promote investor awareness and protect their interests. Administered by the Investor Education and Protection Fund Authority (IEPFA) under the Ministry of Corporate Affairs, the IEPFA plays a crucial role in refunding unclaimed funds and promoting financial literacy. This underscores the importance of investor education as a key aspect of the financial growth of the country.

Similarly, SEBI maintains its own Investor Protection and Education Fund (IPEF) under Section 3 of SEBI (Investor Protection and Education Fund) Regulations, 2009. The IPEF receives contributions from penalties, donations made by listed companies, intermediaries, and fiduciaries for violations of regulatory norms. Section 5 of these regulations' states that the primary utilization of the IPEF is for the education and protection of investors. Additionally, major stock exchanges like the NSE and BSE also maintain their own IPEF accounts, managed by their Investor Protection Fund Trusts, which compensate investors in cases of defaults and promote investor education. SEBI and these stock exchanges undertake various initiatives to educate investors, such as workshops, educational materials, and investor awareness programs designed to improve financial literacy and enable informed decision-making.

Despite the availability of a substantial corpus in its IPEF, SEBI faces significant criticism for its gross underutilization of the fund. As of March 2024, SEBI's IPEF had an impressive balance of ₹533 crore, but only ₹2.8 crore approximately 0.5% of the total fund was utilized during FY24 [47]. This stark underutilization raises concerns about the fund's effectiveness in fulfilling its purpose. Over the years, while the corpus has grown exponentially, expenses directed toward investor education and protection have remained alarmingly stagnant [48]. Though SEBI has launched educational programs like the Securities Market Trainers (SMARTs) Program and the Regional Investor Seminars for Awareness (RISA), these efforts are poorly marketed and lack adequate visibility. Consequently, many potential participants remain unaware of these initiatives, leading retail investors to enter the market without adequate knowledge, often resulting in significant financial losses.

Retail investors, who are the most vulnerable market participants, face the highest risk due to insufficient financial literacy. SEBI must take proactive measures to ensure the effective utilization of its IPEF resources to address this issue. A glaring gap in SEBI's approach is the lack of a robust presence on modern platforms like YouTube, Twitter, and Instagram, where most retail investors actively engage. For instance, the U.S. Securities and Exchange Commission (SEC) provides an exemplary model of effective utilization of investor protection funds. In FY24 alone, the SEC allocated approximately \$200

million as whistleblower [49] rewards for individuals who disclosed frauds and irregularities, ensuring transparency in the market. Additionally, the SEC uses its Investor Protection and Education Fund to launch extensive educational campaigns. It actively leverages platforms like YouTube, Twitter, and Instagram to create awareness about financial markets and investor rights, offering continuous educational content. These efforts enhance market transparency and provide investors with the tools they need to make informed decisions.

In contrast, SEBI's efforts appear outdated and disconnected from the evolving needs of modern investors. While SEBI's initiatives may seem adequate on paper, the lack of practical implementation and the absence of modern outreach strategies significantly reduce their impact. With over ₹533 crore in its IPEF [50], SEBI must focus on targeted campaigns to educate retail investors, who are most prone to losses due to a lack of knowledge and skills. Initiatives should be tailored to bridge the gap between regulatory intent and practical outcomes, emphasizing the importance of investor education and transparency. By adopting a modern, dynamic approach and learning from successful international regulators like the SEC, SEBI can ensure that its efforts genuinely protect and empower investors, fostering a more inclusive and resilient financial market in India.

Introduction of Eligibility Criteria for Entering into the Derivative Market

As a potential solution, SEBI could consider implementing an eligibility criterion for traders entering the derivative market rather than increasing contract sizes, which might inadvertently exclude knowledgeable investors who lack the required margin. Instead, SEBI could introduce a certification course on derivative trading in collaboration with other entities. This certification would be mandatory for retail investors to trade in derivatives. The course should be designed to comprehensively assess investors, including mock trading tests and practical evaluations, ensuring participants possess the requisite skills and knowledge. However, this requirement would not apply to Mutual Funds and Foreign Institutional Investors (FIIs).

To operationalize this system, brokers could be directed to maintain two separate trading windows: one for the cash market and the other for the derivative market. Access to the derivative market window would be granted only to traders holding the required certification. Brokers would be responsible for verifying these certifications, just as they currently verify documents such as Aadhaar and PAN cards during account opening.

The primary purpose of derivatives is hedging. Traditionally, derivatives have been seen as tools for institutional investors like Mutual Funds or FIIs to manage risks. However, recent trends show that many small investors also approach the stock market as a business rather than merely a source of passive income. Despite this shift, there are currently no effective hedging tools available for small investors to protect their investments during adverse market conditions.

Once the eligibility criterion is implemented and proves successful, SEBI could consider reintroducing mini contracts specifically for small investors. These mini-contracts would provide an accessible hedging tool for retail investors, helping them manage risks effectively without needing to meet the high margin requirements of standard contracts.

CONCLUSION

The recent changes introduced by SEBI to regulate the derivative market reflect a decisive attempt to curb speculative activities and enhance market stability. While measures like intraday monitoring of position limits, increased tail risk coverage, and upfront collection of premiums are prudent steps toward fostering discipline and managing risk, other changes, such as the removal of multiple weekly contracts and the increase in contract size, warrant closer scrutiny. The direct elimination of multiple weekly expiries, for instance, seems premature. A phased approach first assessing the impact of the other measures might have been more effective in addressing speculative activity without disrupting the liquidity and diversity brought about by weekly contracts. Similarly, the decision to triple the minimum

contract size risks alienating small retail investors, many of whom engage in derivatives trading to learn, hedge, or test strategies with limited capital. The longstanding reliance on capital-based eligibility criteria for market participation appears increasingly outdated in a time when knowledge and awareness are equally, if not more, critical for effective risk management.

Ultimately, while SEBI's reforms aim to protect investors and enhance the market's integrity, they must strike a delicate balance between curbing excessive speculation and fostering inclusivity. The true efficacy of these changes will only become evident over time, as their impact on market dynamics unfolds. It remains essential for SEBI to remain vigilant and adapt its strategies to ensure that the derivatives market remains both robust and accessible, serving its dual purpose of hedging risks and facilitating price discovery.

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