

CBOE Rule 5.5: Series of Option Contracts Open for Trading

* * * Interpretations and Policies

.01: The interval between strike prices of series of options on individual stocks [will] may be: a. \$1.00 or greater ("1 Strike prices") provided the strike price is \$20.00 or less, but not less than \$3. The listing of \$1 strike prices shall be limited to options classes overlying no more than 5 individual stocks ("The \$1 Strike Pilot Program") as specifically designated by the Exchange. The Exchange may list \$1 strike prices on any other option classes if those classes are specifically designated by other securities exchanges that employ a similar \$1 Strike Pilot Program under their respective rules.

To be eligible for inclusion into the \$1 Strike Pilot Program, an underlying stock must close below \$20 in its primary market on the previous trading day. After a stock is added to the \$1 Strike Pilot Program, the Exchange may list \$1 strike prices from \$3 to \$20 that are no more than \$5 from the closing price of the underlying on the preceding day. For example, if the underlying stock closes at \$13, the Exchange may list strike prices from \$8 to \$18. The Exchange may not list series with \$1.00 intervals within \$0.50 of an existing \$2.50 strike price (e.g., \$12.50, \$17.50) in the same series. Additionally, the Exchange may not list long-term option series ("LEAPS®") at \$1 strike price intervals for any option class selected for the \$1 Strike Pilot Program.

A stock shall remain in the \$1 Strike Pilot Program until otherwise designated by the Exchange. The \$1 Strike Pilot Program shall expire on (insert date one-year from approval).

[a].b. \$2.50 or greater where the strike price is \$25.00 or less, or where the stock represents an interest in a registered investment company that satisfies the criteria set forth in Interpretation and Policy .06 under rule 5.3 and where the strike price is \$200.00 or less; provided, however, that the Exchange may not list \$2.50 intervals below \$20 (e.g., \$12.50, \$17.50) for any class included within the \$1 Strike Pilot Program if the addition of \$2.50 intervals would cause the class to have strike price intervals that are \$0.50 apart.

[b].c. \$5.00 or greater where the strike price is greater than \$25.00, or where the stock represents an interest in a registered investment company that satisfies the criteria set forth in Interpretation and Policy .06 under Rule 5.3 and where the strike price is more than \$200.[,]00;

[c].d. \$10.00 or greater where the strike price is greater than \$200.00.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

CBOE rule 5.5 establishes the guidelines regarding the addition of series for trading on the Exchange. Under CBOE rule 5.5, the Exchange currently has the ability to list \$2.50 intervals for strike prices under \$25, \$5.00 intervals for strikes between \$25 and \$200, and \$10 intervals for strikes above \$200.¹¹ The CBOE notes that stock prices in general have dropped over the past couple of years, with many individual listings registering precipitous declines. As a result, the CBOE currently lists options on more than 800 stocks trading under \$20, including Cisco, Oracle, Sun Microsystems, Lucent, Nortel, JDS Uniphase, Amazon, Nextel, AT&T, Motorola, and Compaq. According to the CBOE, these stocks are among the most widely held and actively traded equities listed on the New York Stock Exchange, Inc. ("NYSE") or Nasdaq and the options overlying these stocks also trade actively.

The CBOE notes that when a stock underlying an option trades at a lower price, it takes a larger percentage gain in the stock for an option to become in-the-money. For example, when a stock trades at \$8 an investor who wants to buy a slightly out-of-the-money call option would have to buy the \$10 call. At these levels, the stock price would need to register a 25% change before it reached \$10 (i.e., in-the-money status). According to the CBOE, a 25% gain in

the underlying is especially large given the lessened degree of volatility that has accompanied many stocks and options over the past several months. Due to the recent preponderance of low priced stocks, member firms have expressed an interest in listing additional strike prices on these classes so that they can provide their customers with greater flexibility in their investment choices. For this reason, the Exchange proposes to implement a one-year Pilot Program, as described below.

Pilot Program Eligibility: The Exchange proposes to amend Interpretation and Policy .01 to CBOE rule 5.5 to allow the CBOE to list series with \$1 strike price intervals on equity option classes that overlie up to five individual stocks, provided that the strike prices are \$20 or less, but not less than \$3. The appropriate Exchange committee would make the determination of which underlying stocks are to be included in the Pilot Program. A class becomes eligible for inclusion in the Pilot Program when the underlying stock price closes below \$20 in its primary market on the previous business day. Underlying stocks trading under \$20 that are not a part of the Pilot Program would continue to be eligible for trading in \$2.50 and \$5.00 intervals.

Although CBOE may select only up to five individual stocks to be included in the Pilot Program, the Exchange would not be precluded from also listing options on other individual stocks at \$1 strike price intervals if other options exchanges listed those series pursuant to their respective \$1 strikes pilot programs.

Procedures for Adding \$1 Strike Price Intervals: The procedures for adding \$2.50 or \$5.00 strikes currently are provided in Exchange rule 5.5.¹² The Exchange proposes to amend CBOE rule 5.5 to delineate these standards to accommodate the addition of \$1 strike price intervals. Under this proposal, the closing price of the underlying stock serves as the reference point for determining which \$1 strike prices the Exchange may open for trading.

To minimize the unnecessary proliferation of series, the Exchange will only list \$1 strike prices that fall within a \$5 range of the underlying stock price, and no strike prices will be added outside of the \$5 range. For example, if

¹¹ Interpretation and Policy .01 to CBOE rule 5.5. Additionally, Interpretation and Policy .05 to CBOE rule 5.5 establishes guidelines for listing \$2.50 strikes for a set number of classes with series trading between \$25 and \$50.

¹² CBOE rule 5.5(c) provides for the addition of series "when the Exchange deems it necessary to maintain an orderly market, to meet customer demand, or when the market price of the underlying stock moves substantially from the initial exercise price or prices." If the Exchange initiates options trading on a new class whose underlying stock is below \$20, rule 5.5(b) governs the establishment of strike prices.