

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 Pilot") 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 Pilot under their respective rules.

To be eligible for inclusion into the \$1 Pilot, an underlying stock must close below \$20 in its primary market on the previous trading day.

After a stock is added to the \$1 Pilot, 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 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 Pilot.

A stock shall remain in the \$1 Pilot until otherwise designated by the Exchange. The \$1 Pilot shall expire on June 5, 2004;

(ii) \$2.50 or greater where the strike price is \$25 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 Pilot if the addition of \$2.50 intervals would cause the class to have strike price intervals that are \$0.50 apart;

(iii) \$5[.00] or greater where the strike price is greater than \$25 but less than \$200[.]; and

(iv) \$10 or greater where the strike price is \$200 or more, except as provided in paragraph (b) below.

The interval of strike prices of series of options on Exchange-Traded Fund Shares will be \$1 or greater where the strike price is [less than \$200 or less.

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 III 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

The PHLX proposes to amend PHLX Rule 1012, "Series of Options Open for Trading," to implement the Pilot Program, which will operate for a pilot period ending on June 5, 2004. The Pilot Program will allow the PHLX to list a finite number of options at \$1.00 strike price intervals pursuant to the Pilot Program. Specifically, the proposal will allow the PHLX to originally list as many as five options at \$1.00 strike price intervals within certain parameters specified in the proposed rule, and to multiply list options classes at \$1.00 strike price intervals where those classes were specifically designated by other securities exchanges that employ a similar \$1.00 strikes pilot program under their rules.

PHLX Rule 1012 establishes guidelines regarding the addition of strike prices for series of options. Currently, the PHLX may list options at \$2.50 intervals where the strike price is \$25.00 or less, at \$5.00 intervals where the strike price is greater than \$25.00 but less than \$200.00, and at \$10.00 intervals when the strike price is \$200.00 or more.⁶ The PHLX notes that over the past two years, prices of stocks in general have dropped, with many listings suffering precipitous declines. As a result, there has been a proliferation of stocks trading below \$20.00, and the PHLX lists options on more than 390 such stocks, including Ford Motor Company, Cisco Systems, Inc., Sun Microsystems, Inc., Corning, Inc., Motorola, Inc., Nextel Communications, Inc., AOL Time Warner, Inc., and Walt Disney Company. According to the PHLX, these stocks trading below \$20.00 are among the most widely held and actively traded equities listed on the New York Stock Exchange, Inc., the American Stock Exchange LLC, and Nasdaq, and the options overlying these stocks also trade actively.

The PHLX notes that when a stock underlying an option trades at lower prices, it requires a larger percentage gain in the price of the stock for the option to become in-the-money. For example, when a stock trades at \$6.00

and a potential investor wants to buy out-of-the-money call options, he or she will have to buy the calls at a \$7.50 strike price. At these pricing levels, the stock would need to achieve a 25% price gain before reaching at-the-money status. Such a 25% or higher gain in the underlying stock is particularly significant in light of the substantially lessened degree of volatility in many stocks and options in the past several months. As a result, the PHLX believes that there is a disincentive for investors to use options on these lowest-tier stocks to manage risk. Additionally, with the recent increase in the number of stocks trading below \$20.00, PHLX member firms have expressed a strong desire to list additional strike prices on these stocks in order to provide their customers with greater flexibility in achieving their investment strategies. The PHLX believes that the proposed Pilot Program would give investors an opportunity to more closely and effectively tailor their options investments to the price of the underlying stock and at the same time would allow the PHLX to take advantage of competitive opportunities to list options at \$1.00 strike prices pursuant to the terms of the Pilot Program.

Moreover, the PHLX believes that implementing the Pilot Program is decidedly pro-competitive. The PHLX believes, and has consistently maintained, that its ability to list options is a significant, and indispensable, component of competition that should not be circumscribed. The PHLX believes that it, like the other options exchanges, should be able to list \$1.00 strike price intervals (pursuant to the terms of the Pilot Program) for the issues that it believes are commercially feasible or desirable. The PHLX maintains that, as history has frequently borne out, yesterday's lowest-performing options, particularly those in the lowest priced trading bracket (*i.e.*, the lowest priced stocks), could well become tomorrow's most desirable options.

For these reasons, the PHLX proposes to implement the Pilot Program, as described below.

Options Eligible for the Pilot Program

The Pilot Program would allow the Exchange to list \$1.00 strike prices on equity options overlying up to five individual stocks provided that the strike prices are \$20.00 or less, but not less than \$3.00. The appropriate Exchange committee will determine which underlying stocks will be included in the Pilot Program. A class becomes eligible for inclusion in the

⁶ See PHLX Rule 1012, Commentary .05. See also PHLX Rule 1012, Commentary .05(b), which establishes guidelines for listing \$2.50 strikes for a set number of classes trading between \$25.00 and \$50.00.