

Pilot Program when the underlying stock price closes below \$20.00 in the primary market on the previous trading day. Underlying stocks trading under \$20.00 that are not a part of the Pilot Program will continue to be eligible for trading at \$2.50 and \$5.00 intervals.

Although the PHLX may select up to five securities to be included in the Pilot Program, the Exchange would not be precluded from also listing options on other stocks at \$1.00 strike price intervals if other options exchanges list those series pursuant to their respective \$1.00 strike price pilot programs.

The Exchange will not list \$1.00 strike price intervals on LEAPS pursuant to the Pilot Program.

Adding \$1.00 Strike Price Intervals

The procedures for adding \$2.50 or \$5.00 strikes are contained in Exchange Rule 1012, Commentary .05, which will be amended to allow the addition of \$1.00 strike price intervals.⁷ Under the proposed Pilot Program, the closing price of the underlying stock will serve as the reference point for determining which \$1.00 strike prices the Exchange may open for trading.

To minimize unnecessary proliferation of series, the PHLX will only list \$1.00 strike prices within a range of \$5.00 greater or \$5.00 less than the closing price of the underlying stock on the primary market on the day before selection by the Exchange. No strike prices will be added outside the \$5.00 range. For example, if the underlying trades at \$6.00, the PHLX could list \$1.00 strikes from \$3.00 to \$11.00. The Exchange believes that this proposed range-format will significantly restrict the number of series that may be added at any one time.

As noted above, PHLX Rule 1012, Commentary .05, currently allows the PHLX to list strike prices with \$2.50 intervals when an underlying stock trades below \$25.00. For this reason, several options have \$7.50, \$12.50, and \$17.50 strike price intervals. To further avoid the proliferation of series, the PHLX does not intend to list \$1.00 strike prices at levels that "bracket," that is, are on either side of, existing \$2.50

intervals (e.g., \$7.00 and \$8.00 strikes around a \$7.50 strike). Accordingly, in this situation, there must be more than \$0.50 between any two strike prices. Thus, if the underlying stock closed at \$5.00, the Pilot Program would permit the Exchange to list options with \$1.00 strike price intervals from \$3.00 to \$10.00, if nothing was trading already at \$5.00 and \$7.50 strike prices, or \$1.00 strike price intervals at \$3.00, \$4.00, \$6.00, \$9.00 and \$10.00, if options were already trading at \$5.00 and \$7.50 strike prices. When the \$2.50 intervals are "phased-out," as described below, the PHLX will introduce \$1.00 intervals that "bracket" the phased-out price. For example, when the \$7.50 series expires, the PHLX will replace it by issuing a new month with \$7.00 and \$8.00 intervals.

Phasing-Out \$2.50 Strike Price Intervals

Once an option becomes part of the Pilot Program, the Exchange will begin the process of phasing-out existing \$2.50 intervals overlying the same stock in favor of \$1.00 intervals. To phase out the \$2.50 intervals, the Exchange initially will delist those \$2.50 series for which there is no open interest. Subsequently, the Exchange will no longer add new expiration months at \$2.50 intervals below \$20.00 when the existing months expire. This process will effectively phase-out the remaining \$2.50 intervals as the farthest-out months expire.

Adding Expiration Months

PHLX Rule 1012 generally allows the Exchange to make available for trading four expiration months for each initial listing of an option. Upon expiration of the near-term month, the Exchange may list an additional expiration month. Under the Pilot Program, if the underlying closed at or above \$20.00 on Expiration Friday, the PHLX would not list an additional month for a \$1.00 strike series until the stock again closed below \$20.00 in the primary market on the day before selection for listing.

Deleting \$1.00 Strike Price Intervals

At any time, the Exchange may cease listing \$1.00 strike prices on existing series by submitting a Cessation Notice to the Options Clearing Corporation ("OCC").⁸ As discussed above, if the

underlying closed at or above \$20.00 on Expiration Friday, the Exchange would not list any additional months with \$1.00 strike prices until the stock subsequently closed below \$20.00 on the primary market on the day prior to the Exchange listing the option. If the underlying stock does not subsequently close below \$20.00, thereby precluding the listing of additional \$1.00 strike prices and months, the existing \$1.00 series would eventually expire. When the near-term month is the only series available for trading in the Pilot Program, the Exchange may submit a Cessation Notice to OCC. Upon submission of that notice, the listing would no longer count towards the five listings that are allowed the Exchange pursuant to the Pilot Program, thereby allowing the PHLX to list classes on an additional stock. Once the Exchange submits the Cessation Notice, it would not list any additional months for trading with strikes below \$20.00 within the Pilot Program unless the underlying once closed below \$20.00, as required by the Pilot Program.⁹

Options Price Reporting Authority ("OPRA") Capacity

The Exchange believes that, according to OPRA figures, there is sufficient capacity to accommodate the Exchange's proposed Pilot Program. The PHLX believes that there is significant excess system capacity at this time: on a daily basis, the options exchanges are using an average of less than 7,000 messages per second ("mps") during peak periods, which is less than 25% of the total system capacity of 32,000 mps.¹⁰ To date, the exchanges have yet to exceed 11,000 mps for any extended period of time.¹¹ Thus, the PHLX believes that implementing the Pilot Program should not have any significant negative impact on OPRA system capacity.

⁹ If the underlying stock trades below \$20.00 after submission of the Cessation Notice by the PHLX, the Exchange could list \$1.00 strike prices again provided it included the class as one of the five classes permitted under the Pilot Program.

¹⁰ Securities Industry Automation Corporation ("SIAC"), which administers and services the network for OPRA, estimates that as much as 6,000 mps of the total system capacity will be used to send best bid and offer ("BBO") messages when the BBO feed becomes operational. See Securities Exchange Act Release No. 47231 (January 22, 2003), 68 FR 4258 (January 28, 2003) (publication of notice of File No. SR-OPRA-2002-01). See also Securities Exchange Act Release No. 47231 (January 22, 2003), 68 FR 4258 (January 28, 2003) (order approving File No. SR-OPRA-2002-01).

¹¹ On November 6, 2002, the OPRA five-minute message peak was 8,203 mps. On November 13, 2002, the one-minute peak was 10,091 mps.

⁷ PHLX Rule 1012(a)(iii) permits the Exchange to add a new option series "as the market price of the underlying stock or Exchange-Traded Fund Share or the underlying foreign currency, as the case may be, moves substantially from the initial exercise price or prices." Moreover, PHLX Rule 1010 provides that where exceptional circumstances have caused an underlying security not to comply with the Exchange's maintenance requirements, "the Exchange may, in the interest of maintaining a fair and orderly market for the protection of investors, determine to open additional series of option contracts on the class covering that underlying security."

⁸ The reasons for submitting a Cessation Notice include: expiration of available \$1.00 strikes (i.e., the underlying stock price on the primary market remains above \$20.00); series proliferation concerns; and delisting because of, among other things, low price, merger, or takeover. In any event, the PHLX would continue to have the ability to cease trading series that become inactive and have no open interest, with prior notice to its members).