

## 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

ISE Rule 504 establishes the guidelines regarding the addition of series for trading on the Exchange. Under ISE Rule 504(d), the ISE currently has the ability to list \$2.50 intervals for strike prices under \$25, \$5 intervals for strikes between \$25 and \$200, and \$10 intervals for strikes above \$200.<sup>4</sup> The ISE currently lists options on 205 stocks trading under \$20, including Cisco, Oracle, Sun Microsystems, Lucent, Nortel, JDS Uniphase, Amazon, Nextel, AT&T, Motorola and Hewlett-Packard. These stocks are among the most widely held and actively traded equities listed on the New York Stock Exchange, Inc. or Nasdaq, and the options overlying these stocks are actively traded as well.

The ISE 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 need to buy the call with a \$10 strike price. At these levels, the stock price would need to register a 25% change before it reached \$10 (*i.e.*, in-the-money status). The ISE notes that 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 Pilot Program, as described below.

**Pilot Program Eligibility:** The Exchange proposes to add Supplementary Material .01 to ISE Rule 504 to allow the ISE 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 Exchange 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 the ISE 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 rules.

**Procedures for Adding \$1 Strike Price Intervals:** The Exchange proposes to adopt new Supplementary Material .01 to ISE Rule 504 to specify the standards that will apply when adding additional \$1 strike price intervals under the Pilot Program.<sup>5</sup> Under the 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. Specifically, 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 the underlying stock trades at \$6, the Exchange could list \$1 strikes from \$3 to \$11.<sup>6</sup> The ISE believes that this proposed range-format will significantly restrict the number of series that may be added at any one time.

Under ISE Rule 504, the Exchange may list strike prices with \$2.50 intervals when an underlying stock trades below \$25. Accordingly, several options classes have \$7.50, \$12.50 and \$17.50 strike prices (the "\$2.50 series" or "\$2.50 intervals"). To further avoid

the proliferation of series, the Exchange does not intend to list \$1 strike prices at levels that "bracket" existing \$2.50 intervals (*e.g.*, \$7 and \$8 strikes would not be added if there is an existing \$7.50 strike). Accordingly, the Exchange will not list \$7, \$8, \$12, \$13, \$17 and \$18 levels in an expiration month where there are corresponding \$2.50 intervals. As the \$2.50 intervals are "phased-out," as described below, the Exchange would introduce the \$1 levels that bracket the phased-out price. For example, when the \$7.50 series expires, the Exchange would replace it by issuing a new month with \$7 and \$8 intervals.

**Procedures for Phasing-Out \$2.50 Strike Price Intervals:** When a stock becomes part of the Pilot Program, the Exchange will begin the corresponding process of phasing-out the existing \$2.50 intervals on the same stock in favor of \$1 intervals. To phase-out the \$2.50 intervals, the Exchange would first delist those \$2.50 series for which there is no open interest. Second, the Exchange would no longer add new expiration months at \$2.50 intervals below \$20 when the existing months expire. This would cause the \$2.50 strike price intervals below \$20 to be phased-out when the farthest-out month with a \$2.50 interval eventually expires.

**\$1 Strikes for Long-Term Options:** The ISE will not list long-term options (also known as "LEAPS") in equity options classes at \$1 strike price intervals.

**Procedures for Adding Expiration Months:** ISE Rule 504(e) will continue to govern the addition of expiration months for all options, including those included in the Pilot Program. Pursuant to this rule, the Exchange generally opens four expiration months for each class upon initial listing of an options class for trading, and upon expiration of the near-term month, the Exchange lists an additional expiration month. With respect to options in the Pilot Program, the Exchange may list an additional expiration month for a \$1 strike series provided that the underlying stock price closes below \$20 on its primary market on expiration Friday. If the underlying closes at or above \$20 on expiration Friday, the Exchange would not list an additional month for a \$1 strike series until the stock again closes below \$20.

**Procedures for Deleting \$1 Strike Price Intervals:** At any time, the Exchange may cease trading options series, including series with \$1 strike prices, by submitting a cessation notice to The Options Clearing Corporation ("OCC").<sup>7</sup> As discussed above, if the

<sup>4</sup> ISE Rule 504(g) establishes guidelines for listing \$2.50 strikes for a set number of options classes with series trading between \$25 and \$50.

<sup>5</sup> ISE Rule 504(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 prices." If the Exchange initiates options trading on a new class whose underlying stock is below \$20, Rule 504(b) governs the establishment of strike prices.

<sup>6</sup> As indicated above, strike prices for options included in the Pilot Program may not be less than \$3 or greater than \$20.

<sup>7</sup> Among the reasons for submitting a cessation notice are the expiration of available \$1 strikes (*i.e.*, Continued