

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

PCX policy establishes the guidelines regarding the addition of series for trading on the Exchange.⁴ The Exchange may list \$2.50 intervals for strike prices at \$25 or less, \$5.00 intervals for strikes over \$25 but less than \$200, and \$10 intervals for strikes at or above \$200.⁵ The PCX currently lists options on more than 400 stocks trading under \$20, including Cisco, Sun Microsystems, Lucent, JDS Uniphase, Nextel, AT&T, Motorola, Intel, Apple, Tyco, AOL Time Warner, and Calpine. 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.

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 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). 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 amend PCX Rule 6.4 in order to list series with \$1 strike price intervals on equity option issues that overlie up to five individual stocks, provided that the strike prices are \$20 or less, but not less than \$3. The PCX's Options Listing Committee would make the determination of which underlying stocks are to be included in the Pilot Program. An issue becomes eligible for inclusion in the Pilot Program when the underlying stock 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 PCX 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 Exchange proposes to amend Rule 6.4 to specify the standards that will apply when adding additional \$1 strike price intervals under the Pilot Program. 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 \$11.⁶ The Exchange believes that this proposed range-format will significantly restrict the number of series that may be added at any one time.

The Exchange may currently list strike prices with \$2.50 intervals when an underlying stock trades below \$25.⁷ Accordingly, several option issues 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 around a \$7.50 strike). Accordingly, the Exchange does not intend to list \$7, \$8, \$12, \$13, \$17, and \$18 levels in an expiration month where there is a corresponding \$2.50 level. 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 LEAPS

The Exchange will not list long-term options (also known as "LEAPS") in equity option classes at \$1 strike price intervals.

Procedures for Adding Expiration Months

PCX Rule 6.4 will govern the addition of expiration months for the Pilot Program. Pursuant to this rule, the Exchange generally opens up to 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 strike 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 \$1strike 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

⁴ See Securities Exchange Act Release No. 21985 (April 25, 1985), 50 FR 18595 (May 1, 1985) (order approving File Nos. SR-PSE-85-9 and PHLX-85-9) ("1985 Order").

⁵ See 1985 Order, *supra* note 4. Additionally, PCX Rule 6.4, Commentary .03 establishes guidelines for listing \$2.50 strikes for a set number of issues with series trading between \$25 and \$50.

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

⁷ See 1985 Order, *supra* note 4.