

September 28, 2007

Nancy Morris, Secretary
U.S. Securities and Exchange Commission
100 F St., NE
Washington, D.C. 20549

Re: S7-19-07

Dear Ms. Morris,

Thank you for allowing Group One Trading, LP (Group One) the opportunity to comment on the proposed amendment to Regulation SHO that would eliminate the Options Market Maker (OMM) hedge exception (the OMM Exception) to the close-out requirement of Regulation SHO. As an introduction, Group One is a proprietary options market maker that makes markets on 5 Exchanges and is a Specialist, Designated Primary Market Maker, or Lead Market Maker in about 1450 option classes. We respectfully would like to make the following points:

1. The Commission has Not Demonstrated a Link Between Proper Reliance on the OMM Exception and Fails to Deliver

Group One does not believe the Commission has demonstrated any link between lingering fails to deliver and proper reliance on the OMM Exception. The data relied upon by the Commission in concluding the OMM Exception may lead to fails to deliver is merely speculation and guesswork. The data relied upon by the Commission can be summarized as follows: a) the NYSE and OCIE have each found a broker-dealer who failed to close-out fails in threshold securities, and these two broker-dealers (who may even have been the same broker-dealer for all we know) claimed they were relying on the OMM Exception, and b) the NASD found that in a small subset of Nasdaq securities with persistent fails to deliver, the clearing firms with these fails were known to clear for options market making firms.

With respect to the NYSE and OCIE data, it is not possible to conclude the OMM Exception was responsible for the persistent fails to deliver since it is not known whether the firms were 1) options market making firms, 2) engaging in bona fide market making, and 3) properly claiming the OMM Exception.

With respect to the NASD data, it is not possible to conclude the OMM Exception was responsible for the persistent fails to deliver since it is not known whether 1) the clearing firms' fails were due, in whole or in part, to fails by OMM, 2) to the extent the fails were caused by OMMs, were the OMMs claiming the OMM Exception, and 3) if the OMMs were claiming the exception, were they entitled to rely upon it.

In light of the lack of evidentiary support linking the OMM Exception to persistent fails to deliver, we strongly believe the Commission has no basis to eliminate the OMM Exception. Furthermore, since the Commission has recently eliminated the Grandfather Clause (a step we believe will greatly reduce persistent fails to deliver), we suggest that the Commission wait to see the results of such change before studying further whether persistent fails remain, and if so, to what extent such fails are attributable to the OMM Exception.

2. The Elimination of the OMM Exception Will Hurt Liquidity

We are concerned the elimination of the OMM Exception will harm OMMs' ability to offer liquidity and narrow quote widths with respect to a large number of options, well beyond threshold securities. We believe that the dynamic nature of the threshold list will cause the liquidity to disappear in many securities where OMMs believe the underlying stock may become a threshold. We would ask the Commission to consider that while on any given day the number of threshold securities is about 200 to 300 securities, the names on that list fluctuate by about 7% per day, making it relatively difficult (if not impossible) to determine which stocks will be on the list on any given day. While it's true that the current close-out rule has not decreased liquidity after a stock has gone on the threshold list, this does not mean that liquidity will not be harmed in non-thresholds if the OMM Exception is eliminated.

Our belief is, simply, that if OMMs lose their ability to hedge their options market making activity in non-thresholds without fear of being closed-out, OMMs will be less likely to make markets, and the markets they do make will feature wider spreads to account for the increased risk. It's doubtful that any market makers will want to make LEAP (i.e., long-term options) markets, for example, in issues that may possibly go on the list. Since the list of issues that could possibly go on the list is fairly large, this will reduce liquidity in a huge number of names. A good example of this would be the fairly large amount of business in the private equity marketplace. Any of these deals could cause a security to become a threshold in any number of large cap names. To avoid the risk of having outstanding LEAPs that cannot be hedged, we believe OMMs will abandon the market in LEAP and far term options and liquidity will disappear.

Another important factor to consider when looking at Reg SHO and how it will affect the marketplace is how fails occur. Right now, when an OMM shorts a stock, it can fluctuate between failing and not failing just based on what its clearing firm has available for delivery. There is little to no transparency to this process, so it becomes extremely difficult to determine which issues the OMM will fail on, and when. So without a better system (which we doubt can be put in place) for figuring out which stocks an OMM can short without failing, OMMs run the risk of ending up on the fails list at any time in almost any security. This fact will create too much uncertainty in the marketplace, increases OMM risk and will be yet another factor that creates a significant drop in liquidity.

The bottom line here is that elimination of the OMM Exception rule will create significant reductions in liquidity that are going to harm a very broad customer base. This will make it significantly more difficult for the general public (who tend to be long equities) from hedging their portfolios, particularly in the long term.

Our beliefs are strongly supported by a recent study announced by the Vodia Group, LLC finding that elimination of the OMM Exception will harm liquidity.¹

3. The Commission has Not Demonstrated that, from an Economic Perspective, the Benefits of the Elimination of the OMM Exception Outweigh the Harm

The Commission's entire cost-benefit analysis is premised upon the assumption that the OMM Exception is responsible for "large and persistent fails to deliver" that have a harmful impact (ex., possibly depriving shareholders of the benefits of ownership; ex., a possible increase in artificial market influences on a security's price), and that once the OMM Exception is eliminated, these harms will disappear. The deepest flaw in the Commission's analysis is that it has no evidence to suggest that OMMs properly relying on the OMM Exception are responsible for a significant portion of such fails to deliver. As a result, we believe the Commission's cost-benefit analysis fails completely. Furthermore, the Commission speculates regarding many harms caused by fails to deliver, but also does not have any concrete evidence that such harms actually do result from "large and persistent fails to deliver" (this can be seen in the Commission's repeated use of the word "may" when describing possible harms from fails to deliver). As a result, we do not believe the Commission has shown any benefit (or avoided harm), economic or otherwise, to eliminating the OMM Exception.

4. Misunderstanding of the OMM Exception

Despite the lack of evidence provided by the Commission that OMMs are responsible for persistent fails to deliver, we believe it is possible that a portion of persistent fails to deliver may be attributable to fails by OMMs. However, as expressed by the Commission, this may be due more to the fact that OMMs do not understand the limitations of the exception and are reading it more broadly than it is written. The Commission has stated that "it has become apparent to us during the comment process that the language of the current [OMM Exception] is being interpreted more broadly than the Commission intended, such that the exception seems to be operating significantly differently from our original expectations. Thus, we are concerned that options market makers are claiming the exception even where options positions are created after the underlying security becomes a threshold security."

To the extent OMMs are misinterpreting an exception, the first step should not be the elimination of the exception and the possible adverse consequences on liquidity, spreads, etc. We believe a more prudent first step would be an effort by the Commission and the

¹ "Vodia Group Publishes Impact of Reg SHO Options Market Maker Exemption on Options Liquidity" dated September 17, 2007, available at http://www.vodiagroup.com/pdfs/Reg_SHO_Options%20Exemption.pdf

options exchanges to educate OMMs through regulatory notices, interpretations, and examinations. Misunderstanding of an exception that many, including Group One, believe has beneficial market impact, should not form the basis for elimination of such exception.

5. Current Regulation SHO is Unclear as to How an OMM May Permissibly Close-Out a Fail in a Threshold Security

We think there may be issues with the clarity of the current OMM Exception, and that without getting clarity, it is not possible to see if the OMM Exception really creates the supposed harm the Commission speculates it causes. Additionally, we feel that it is currently very unclear how an OMM may close-out a fail to deliver then later re-sell a security or engage in options activity without being accused of trying merely to evade complying with the close-out requirement.

It appears that an equity market maker can buy stock to close-out a fail, and reestablish their short position the very next day. So, an equity market maker can buy stock in the open marketplace, which could very likely be from another market participant who is going to fail, and then reestablish their failing short the following day. This does nothing to deal with closing out and reducing fails which is the Commission's stated goal (the only way this is effective at reducing fails is to make it potentially economically unfeasible to use this strategy). At the same time, there is a significant lack of clarity regarding how a OMM can effect a close out. Much of what we have heard regarding the issues facing OMMs' close-outs relate to the time that a failing short is covered (assuming it is hedged with an options position, which is generally what OMMs do for a living). We have also heard that there are issues with the timing of when a short is reestablished. We feel that this creates a significant discrepancy in the market place since most OMMs have options hedging their positions to begin with (we use the short stock as a hedge to an options position). This creates an uneven playing field with the Commission trying to act as arbiter of how someone should close out their position and deciding that a more economic alternative is not legal simply based on the desire to reduce fails (which the Commission is not accomplishing anyway assuming that you can still close out by buying back the position).

We would like some clarity on what types of trades constitute an acceptable close-out and what types do not. We have a considerable number of examples we can share with the Commission, and would be happy to do so. Without clarity on this important piece of the rule, it will be impossible to make markets in threshold securities.

6. If Any Amendment is Made, Alternative 1 (35 Days to Close-Out A Fail) Should Be Adopted

If the Commission decides it nevertheless must adopt an amendment to the OMM Exception, we suggest it take the most measured step among the proposed alternatives (35 settlement days to cover a failing position in a threshold security). At the same time, we feel that even this amendment will force OMMs to focus and only provide deep and

tight markets in the first two expirations, leaving many investors without an opportunity to hedge their positions on a longer-term basis.

Conclusion

For the reasons set forth above, we believe the Commission should not adopt the proposed amendment eliminating the OMM Exception to the Close-out Requirement of Regulation SHO. We would be happy to discuss this further with the Commission and its staff.

Sincerely,

John Gilmartin
Co-CEO
Group One Trading, LP

Ben Londergan
Co-CEO
Group One Trading, LP