

Rev. Proc. 2002-11 sets forth the procedures that an exchange must follow to obtain a ruling regarding whether certain persons trading on that exchange qualify as “dealers” in SFCs or options on such contracts for purposes of § 1256(g)(9)(B). In addition, Rev. Proc. 2002-11 provides that after the issuance of a letter ruling to an exchange, it is expected that the IRS will publish the same conclusion in a revenue ruling that may then be relied upon by qualifying exchange members.

FACTS

Exchange has been designated by the Commodity Futures Trading Commission (CFTC) as a contract market that is permitted to list SFCs. Exchange has a market maker program under which Exchange members may qualify as Exchange Market Makers. Exchange Market Makers are obligated to provide liquidity for their specifically assigned SFC products that trade on Exchange. For this purpose, an SFC product consists of contracts that may have varying maturities but that all relate to a particular underlying security or a particular narrow-based index of securities. Exchange Market Makers fall into one of three classes: Class 1, Class 2, and Class 3. Class 1 Market Makers are assigned at least a, if not all, SFC products listed on Exchange. Class 2 Market Makers are assigned b to c SFC products listed on Exchange. Class 3 Market Makers are assigned fewer than b SFC products listed on Exchange.

An Exchange Market Maker must meet all of the following requirements:

- (1) Be a member of Exchange;
- (2) Be registered as a floor trader or floor broker with the CFTC or as a dealer with the Securities Exchange Commission (SEC);
- (3) Maintain records sufficient to prove compliance with the Exchange Market Maker requirements, including, but not limited to, documents concerning personnel effecting relevant orders, relevant trade and cash blotters, relevant stock records, and documents concerning applicable internal system capacity and performance; and
- (4) Hold itself out as willing to buy and sell SFCs for its own account on a regular or continuous basis.

For an Exchange Market Maker to fulfill the regular or continuous requirement in (4), it must satisfy the following criteria for each of its assigned SFC products:

- (i) Provide continuous two-sided quotations for the first two delivery months of each assigned SFC product throughout the trading day, except during unusual market conditions as determined by Exchange (such as a fast market in either the SFC product or the security underlying the SFC

product) at which times the Market Maker must use its best efforts to quote continuously and competitively;

(ii) Quote for the first two delivery months, with (A) a maximum bid/ask spread no more than the greater of \$d or e% of the bid/ask spread in the primary market for the security underlying the SFC product and (B) a minimum number of contracts no less than the lesser of f contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the SFC product;

(iii) Respond to requests for quotation in each assigned SFC product within g seconds for all delivery months other than the first two delivery months with a two-sided quotation that has (A) a maximum bid/ask spread no more than the greater of \$h or e% of the bid/ask spread in the primary market for the security underlying the SFC product and (B) a minimum number of contracts no less than the lesser of g contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the SFC product; and

(iv) The requirements in (i) - (iii) must be fulfilled for all assigned SFC products and the assigned SFC products in the aggregate must account for at least i% of the total volume in all SFCs traded on Exchange for the preceding calendar quarter.

Any Exchange Market Maker that fails to comply with the Exchange rules, CFTC rules, or SEC rules, as applicable, is subject to disciplinary action in accordance with Exchange rules.

LAW

Section 1256(g)(7)(B) defines the term “qualified board or exchange” to include a domestic board of trade designated as a contract market by the CFTC.

Section 1256(g)(8)(A) defines the term “options dealer” to mean any person registered with an appropriate national securities exchange as a market maker or specialist in listed options. Section 1256(g)(9)(B) provides that a person shall be treated as a dealer in SFCs or options on such contracts if the Secretary determines that such person performs, with respect to such contracts or options, as the case may be, functions similar to the functions performed by an options dealer. Section 1256(g)(9)(B) further provides that such determination shall be made to the extent appropriate to carry out the purposes of this section.

The legislative history for § 1256(g)(9) states the following with respect to the determination process:

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

H.R. Conf. Rep. No. 106–1033, at 1036 (2000).

CONCLUSIONS

(1) Exchange is a “qualified board or exchange” within the meaning of § 1256(g)(7).

(2) It is determined that Class 1, Class 2, and Class 3 Market Makers that function as described above perform functions similar to the functions performed by options dealers (as defined in § 1256(g)(8)(A)) and that these Exchange Market Makers are therefore dealers in SFCs within the meaning of § 1256(g)(9)(B).

This ruling is directed only to the taxpayer who requested it. Members of Exchange may not rely upon its conclusion. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Except as expressed herein, no opinion is expressed or implied concerning the tax consequences of any activities of Exchange, its members or any other parties having any connection to Exchange. In particular, no opinion is expressed or implied regarding whether any particular SFC in the hands of an SFC dealer constitutes a dealer SFC under § 1256(g)(9)(A).

It is expected that a revenue ruling will be issued that is substantially consistent with this letter ruling. That revenue ruling will specify the effective date of any determination made under § 1256(g)(9)(B). In the event that the revenue ruling varies from this letter ruling, this letter ruling will be treated as modified and superseded by the revenue ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Exchange's authorized representative.

Sincerely yours,

PATRICK E. WHITE
Senior Counsel, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:

Copy of this letter
Section 6110 Copy