

Internal Revenue Service

Number: **200448036**

Release Date: 11/26/04

Index Number: 1256.00-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:B01

PLR-148371-02

Date:

August 6, 2004

LEGEND

Exchange =

Class 1 =

Class 2 =

a =

b =

c =

d =

e =

f =

g =

h =

Dear :

This is in reply to a letter dated August 29, 2002, and subsequent correspondence, submitted by your authorized representative in accordance with Rev. Proc. 2002-11, 2002-1 C.B. 526, requesting a ruling that a Class 1 or Class 2 Exchange Market Maker that functions as described below and satisfies the Section 1256 Dealer Qualification quotation requirements described below is a dealer in securities futures contracts (SFCs) within the meaning of § 1256(g)(9)(B) of the Internal Revenue Code.

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. As such, Exchange is a “qualified board or exchange” within the meaning of § 1256(g)(7). Exchange has a market maker program under which Exchange members may qualify as Exchange Market Makers eligible for the market maker exclusion provided in Exchange’s customer margin rules. 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.

A Class 1 or Class 2 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 and Exchange Commission (SEC);
- (3) Maintain records sufficient to prove compliance with Exchange Market Maker requirements and the related regulations and rules of the CFTC or SEC, as applicable, including, without limitation, trading account statements and other financial records sufficient to detail activity; 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, as applicable, for each of its assigned SFC products:

Class 1 Market Maker - The member provides continuous two-sided quotations throughout the trading day for all delivery months of all assigned SFC products (where such assigned SFC products represent in the aggregate at least a meaningful proportion of the total trading volume on Exchange), except during unusual market conditions as determined by Exchange (such as a fast market in either an SFC product or a security underlying an SFC product), at which time the member must use its best efforts to quote continuously and competitively; and, when the member provides quotations, it quotes for a minimum of a SFC with a maximum bid/ask spread of no more than the greater of \$b or c% of the bid/ask spread in the primary market for the security underlying each SFC product; or

Class 2 Market Maker - The member responds to at least d% of the requests for quotation (RFQs) for all delivery months of all assigned SFC products (where such assigned SFC products represent in the aggregate at least a meaningful proportion of the total trading volume on Exchange), except during unusual market conditions as determined by Exchange (such as a fast market in either an SFC product or a security underlying an SFC product), at which times the member must use its best efforts to quote competitively; and, when the member responds to RFQs, it quotes within e seconds for a minimum of a SFC with a maximum bid/ask spread of no more than the greater of \$b or c% of the bid/ask spread in the primary market for the security underlying each SFC product.

For purposes of the preceding requirements for Class 1 and Class 2 Market Makers, a “meaningful proportion of the total trading volume on Exchange” means a minimum of f% of the trading volume of SFCs traded on Exchange during the 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.

Section 1256 Dealer Qualification. Class 1 and Class 2 Market Makers seeking to qualify as a § 1256(g)(9)(B) dealer under Exchange's market maker program must agree to meet the minimum quotation size requirements described below for all of their assigned SFC products that are specified for purposes of the market maker exclusion provided in Exchange's margin rules.

Class 1 and Class 2 Market Makers must provide continuous two-sided quotations or respond to requests for quotations in accordance with the applicable obligations set forth above by quoting:

(a) g contracts for each product not covered by (b) or (c);

(b) e contracts for each product specified by the member to the extent such quotations are provided for delivery months other than the next two delivery months then trading; and

(c) a contract for any single stock futures contract where the average market price for the underlying stock was \$h or higher for the preceding calendar month or for any narrow-based stock index futures contract, as defined by § 1a(25) of the Commodity Exchange Act.

LAW

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).

CONCLUSION

It is determined that Class 1 and Class 2 Market Makers that function as described above and satisfy the Section 1256 Dealer Qualification quotation requirements 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