

## **Section 1256.—Section 1256 Contracts Marked to Market**

**Dealers in securities futures contracts.** This ruling holds that Tier 1, Tier 2, and Tier 3 NQLX LLC Market Makers that satisfy the market maker requirements described in the ruling perform functions similar to the functions performed by options dealers (as defined in section 1256(g)(8)(A) of the Code) and that these NQLX LLC Market Makers are therefore dealers in securities futures contracts within the meaning of section 1256(g)(9)(B).

### **Rev. Rul. 2004-94**

#### **ISSUE**

If a Tier 1, Tier 2, or Tier 3 NQLX LLC (NQLX) Market Maker satisfies the requirements described below, is it a dealer in securities futures contracts (SFCs) within the meaning of § 1256(g)(9)(B) of the Internal Revenue Code?

#### **FACTS**

NQLX has been designated by the Commodity Futures Trading Commission (CFTC) as a contract market that is permitted to list SFCs. As such, NQLX is a “qualified board or exchange” within the meaning of § 1256(g)(7). NQLX has a market maker program under which NQLX members may qualify as NQLX Market Makers. NQLX Market Makers are obligated to provide liquidity for their specifically assigned SFC products that trade on NQLX. 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. NQLX Market Makers fall into one of three classes: Tier 1, Tier 2, and Tier 3. Tier 1 Market Makers are assigned at least 50, if not all, SFC products listed on NQLX. Tier 2 Market Makers are assigned

25 to 49 SFC products listed on NQLX. Tier 3 Market Makers are assigned fewer than 25 SFC products listed on NQLX. In each case, the SFC products assigned to a Market Maker in the aggregate must account for at least 20% of the total volume in all SFCs traded on NQLX for the preceding calendar quarter.

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

(1) Be a member of NQLX;

(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 NQLX 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 NQLX Market Maker to fulfill the regular or continuous requirement in paragraph (4) above, 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 NQLX (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 of no more than the greater of \$0.10 or 150% of the bid/ask spread in the primary market for the security underlying the SFC product and (B) a Minimum Number of Contracts of no less than the lesser of 10 contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the SFC product; and

(iii) Respond to requests for quotation in each assigned SFC product within 5 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 of no more than the

greater of \$0.20 or 150% of the bid/ask spread in the primary market for the security underlying the SFC product and (B) a Minimum Number of Contracts of no less than the lesser of 5 contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the SFC product.

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

## 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 that 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).

## HOLDING

It is determined that Tier 1, Tier 2, and Tier 3 NQLX Market Makers that satisfy the requirements described above perform functions similar to the functions performed by options dealers (as defined in § 1256(g)(8)(A)) and that these NQLX Market Makers are therefore dealers in SFCs within the meaning of § 1256(g)(9)(B). This determination will cease to apply in the event of material changes in the NQLX Market Maker program affecting the Tier 1, Tier 2, or Tier 3 Market Makers described above. See § 601.601(d)(2)(v) of the Income Tax Regulations.

## EFFECTIVE DATE

The effective date of this ruling is the date of publication in the Internal Revenue Bulletin. Because this ruling is prospective only, the holding applies to SFCs that are entered into by a dealer in SFCs on or after the effective date of this ruling.

## DRAFTING INFORMATION

The principal author of this revenue ruling is K. Scott Brown of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact K. Scott Brown at (202) 622–3920 (not a toll-free call).