

CDS TRADING Q&A

Global regulation is set to dramatically change the way credit default swaps (CDS) are traded. Below we have attempted to answer some of the most frequently asked questions in relation to how MiFID II is likely to impact e-trading of OTC products.

1. What is MiFID II and how will it impact electronic trading?

MiFID II is the review of the Markets in Financial Instruments Directive, which seeks to create a single and competitive market in financial services across all EU member states. The European Commission regards the current revision of MiFID as a major part of the continuing structural reforms it considers are needed following the global financial crisis.

MiFID II proposes to include requirements for 'best execution' which relate to the content and format of data, as well as frequency of data publication, and as such would encourage more widespread use of electronic trading venues across a broad range of products. In addition, as currently proposed, MiFID II seeks to establish a consolidated trade tape for Europe, which would bring additional transparency to the markets.

2. What is the timetable for MiFID II?

Between December 2010 and February 2011 the European Commission (EC) held a consultation on MiFID II, to which they received 4,200 responses. Following the consultation, in October 2011, the EC adopted formal proposals for a Directive on markets in financial instruments, and for a Regulation on markets in financial instruments (MiFIR) which would also amend the proposed European Market Infrastructure Regulation (EMIR) on OTC derivatives, central counterparties and trade repositories. The proposals are currently passing through the EU's legislative process, and although the measures were expected to be adopted by end-2012 in order to meet the G20 deadline for all standardized derivative contracts to be traded on exchanges or electronic platforms by that date, this is now likely to take place in the first half of 2013.

3. What steps has MarketAxess taken to prepare for implementation of MiFID II?

First, MarketAxess has also been actively engaged in the ongoing regulatory reform agenda with European policy makers. We have hosted roundtables with policy makers and submitted our thoughts and feedback on the proposals, sharing our extensive experience of electronic trading in the OTC markets.

Second, we are fully engaged with market participants, including buy- and sell-side customers, affirmation hubs, and central clearing organizations, to prepare for these changes. Our progress is reflected in a tripling of our client-to-dealer CDS trading volume from 1Q12 to 2Q12.

Third, in response to the anticipated requirements of the Dodd-Frank Act in the U.S., we have built and now offer multiple protocols to trade CDS indices and CDS single-names, including: request-for-quote (RFQ); request-for-market (RFM); live markets with streaming, executable prices for CDS from multiple dealers; and list trading.

4. What is an OTF?

The European Commission's consultation proposed a new regulatory category of trading venue – “organized trading facilities” (OTFs) – in order to capture any facility or system that brings together buying and selling interests that was not caught by one of MiFID's existing venue classifications.

As currently understood, OTFs would include both bilateral and multilateral systems, capturing all types of organized execution and trading arrangements not covered by regulated markets or MTFs (multilateral trading facilities). This includes broker crossing systems and electronic platforms for the trading of OTC derivatives.

OTF operators under MiFID II should be neutral and may not execute any transactions against their own capital, but they will have discretion over how a transaction will be executed and may restrict access to clients with which they do not want to trade. Under this definition, OTFs could include single-dealer platforms. In this respect OTFs differ from SEFs, as it does not appear that the SEF rules will permit single dealer platforms.

5. What is an MTF?

A Multilateral Trading Facility (MTF) is a type of trading venue that is operated by an investment firm or market operator, bringing together multiple third-party buying and selling interests in financial instruments in a non-discriminatory way. An MTF may not reject particular members or participants.

MarketAxess Europe Ltd. is registered as an MTF.

6. Is there likely to be a consolidated trade tape in Europe as a result of these regulations?

The European Commission considers that transparency of market data is crucial. The EC set out proposals within its consultation regarding the scope of transaction reporting, the content of transaction reports and the mechanisms for making transaction reports.

The EC's consultation suggested three options for entities dealing with the collection and publication of trading data. Option A proposed a mandated consolidated tape, similar to the model used in the U.S. (FINRA's TRACE), which is operated by a single, non-profit-seeking entity. Option B suggested the establishment of a commercial consolidated tape, operated by a single commercial entity. Option C would allow competing commercial providers to provide a consolidated tape as long as they comply with certain conditions.

While there is agreement within the European Union that a consolidated tape is needed, there is currently no final consensus as to the form of the tape and how it will be operated.

7. What percentage of the market do you believe will trade electronically?

The potential size of the market will depend on how the regulators define which swaps are standard and must be cleared through one of the clearing institutions. Based on DTCC trade warehouse and other publicly available data, MarketAxess estimates that the current total average daily trading volume in the global client-to-dealer CDS market is between \$40 and \$50 billion in notional value, including indices and single-name CDS. Our current expectation is that

at least 75% of the daily CDS trading volume will represent clearable swaps that will have to be traded on an exchange or through a SEF according to the Dodd-Frank Act as currently proposed.

8. Is any of the CDS market likely to migrate to exchange trading?

Much like the cash market in credit instruments, liquidity in CDS can be thin and discontinuous for a number of structural reasons. Although we expect the most actively traded index products to be fairly liquid in the context of the market, most of the single-name CDS and many of the less actively traded indices will be substantially less so. We believe the trading protocols available on MarketAxess, including our sophisticated RFQ capabilities that are tailored to less liquid markets, are more suited than a 'central limit order book' (CLOB) or exchange model to the type of trading typically done in CDS. That said, given the range of liquidity across the CDS market, we intend to offer clients a choice in protocols available for trading CDS.

9. What will be your relationship with the clearing organizations?

As an independently-owned MTF, we anticipate connecting to the clearing organizations to deliver trades executed on our platform to the clearing organization of the counterparty's choice. As the regulatory rulemaking evolves, we will continue to work actively with all industry participants to best understand and address the needs of the market.

10. What are MarketAxess' capabilities in CDS?

We provide a comprehensive suite of CDS trading capabilities. MarketAxess offers institutional investors a single trading platform with easy access to multi-dealer competitive CDS pricing. The streamlined RFQ trading protocol gives investors live, executable levels in both index and single-name CDS. Investors can also trade baskets of CDS single-names using our patented list trading protocol, which is a proven efficiency tool. In addition, we offer live, 'streaming markets' for CDS indices in both the U.S. and Europe, including U.S. high grade and high yield indices (CDX), as well as European indices (iTraxx). CDS single-name trading includes investment grade, high yield and emerging markets names.

Our straight-through processing, post-trade feeds and reporting capabilities can deliver significant operational efficiencies to CDS market participants. We also plan to augment our superior trade execution capability with robust pre-trade CDS analytics featuring Markit intraday index pricing.