

Josanco Floreani (Italy), Maurizio Polato (Italy)

The distribution of illiquid financial products within the Mifid framework. New challenges for the European financial industry

Abstract

The investment in illiquid financial products introduces various profiles of criticality related to the client's perception of risk and to the intermediaries' commercial policies. However, the notion of illiquid product could be affected by some misunderstanding such as the tendency (which constitutes a simplification) to identify it as the *trading venue*, so as only those products are illiquid which are negotiated over the counter. Really, it is necessary to assess the degree of liquidity based on the characteristics of the financial product, those of the issuer and the eventual market of negotiation. From a substantial point of view, this has some important implications regarding the regulatory profiles of investor's protection. The Mifid in Europe set conduct of business rules to align the behavior of the intermediary with the duty to serve the investor at best. The harmonization of the conduct rules passes from the implementation of the level 3 measures. This paper examines the problem in the light of the implementation of level 3 measures in Italy.

Keywords: illiquid financial instruments, Otc markets, pricing, transparency.

JEL Classification: G11, G12, G21, G23.

Introduction

It is well recognized that less expert investors are exposed to risks of opportunistic behaviors by intermediaries due to information asymmetries and a limited ability to properly understand risks. Recent evidences put to the forefront the habit of intermediaries to sell the client financial products for which an active market doesn't exist, due to inherent characteristics or factual circumstances. For so called illiquid financial products the risk of *miss-selling* practices is greater and claims for tight conduct of business rules for intermediaries.

However, it does not appear simple to completely define the features of an illiquid product. The simpler approach focuses on the venue where such products can be traded. Accordingly, a financial product would be illiquid as a transparent and orderly functioning market (regulated or organized market) for it lacks. However, certain Otc financial products could benefit from the engagement of an intermediary to support the liquidity. By contrast, several instruments negotiated on regulated markets are characterized by limited levels of liquidity. Moreover, during a financial turmoil or in circumstances that determine a generalized draining of the liquidity, the same instruments that normally have an active market can become illiquid.

When investing in illiquid financial products the investor, particularly the retail one, is exposed to risks which in some way differ from those entailed by other investments. Apart from the volatility of pricing which is greater, the investor lacks important peaces of information in order to make a proper decision.

This claims for a new approach in selling financial products to clients which should focus in more detail

on their characteristics. The aim of the present work is to discuss how the evolving regulatory environment may redefine the relations with the client.

The methodology we employ first identifies the features and risks entailed by an illiquid investment which may affect portfolio choices according to the different characteristics of the investor. Then we address the remedies which would be best suited for aligning the intermediaries' behavior and the clients' interest. Drawing on Mifid level 3 measures entrusted by Consob (see Communication no. 9019104 dated 2 march 2009 on www.consob.it), the Italian supervisor, we emphasize the main criticalities in regulating the matter. Our work is new in that it analyzes the implications of the new regulatory approaches to the distribution of illiquid products to retail customers. What is lacking in main theoretical works, in fact, is the role of regulation in affecting portfolio behavior of investors. Although it may appear something reductive, focusing on the Italian case would be the starting point to draw some important implications regarding the trade off between investor protection and intermediaries' commercial policies.

The work is organized as follows. In section 1 we will address the liquidity issue and its implications for retail customers. In section 2 we will discuss the main issues related to ruling intermediaries' behavior in distributing illiquid financial products to clients. In section 3 we will discuss the main challenges for the financial industry. The last section concludes.

1. Investing in illiquid financial products: is there a clientele effect?

Investing in illiquid financial instruments exposes the investor to *miss-selling* practices and opportunistic behavior by the intermediary. Since the issuer often plays the role of distributor, he may have a clear incentive to behave in an unfair manner

recommending and placing products with potentially high profitability and immediate economic returns.

The distribution of certain structured finance products is an important source of returns for banks constituted by upfront commissions and *mark-ups*. In recent times, moreover, banks had a great incentive to distribute own products (above all bonds), often highly illiquid, in order to resolve problems of funding. Such contingencies forced intermediaries to focus on the mere distribution function instead of concentrating on the quality of the services offered to the customers.

Evidence (Bank for International Settlements, 2008a) shows how intermediaries are renitent in disclosing important pieces of information to the clients, especially those referring to conflicts of interests, risks and costs (both direct and indirect). Such an unfair behavior has important implications for less expert investors who, generally, although not able to properly evaluate all the risks related to an investment, invest greater fractions of their wealth in assets that may entail some liquidity risk such as insurance products and, to a less extent, long-term securities and non quoted shares. Table 1 reports the main assets of households as percentage of GDP.

Table 1. Households' assets (% of GDP)

	2004	2005	2006	2007
Short-term securities other than shares and financial derivatives	7,78%	7,71%	7,76%	8,53%
Long-term securities other than shares and financial derivatives	12,79%	11,62%	11,42%	11,44%
Non quoted shares	7,51%	7,73%	8,54%	8,70%
Derivatives	2,19%	2,21%	2,27%	2,79%
Life insurance reserves and pension funds	37,19%	38,14%	38,30%	39,35%

Source: Our elaborations on Eurostat.

In fragmented, decentralized and opaque markets lack of transparency may undermine the price discovery process and involve high transaction costs so as an investor wishing to get out of an investment position quickly may find himself trapped with the consequence that he cannot sell or, otherwise, have to bear high costs. Lack of liquidity turns to widen spreads. The phenomenon is strictly related to the features of the secondary market. Not only the lack of an active market may entail liquidity risks but also securities for which an organized market existing may trade under conditions of weak liquidity as well. The problem is evident, for example, for several small cap stocks and for several bonds as well. Moreover, derivatives embedded in certain structured products raise the uncertainty of pay offs.

A wide field of research accounts for a strict relation between trading costs and transparency, with costs becoming as higher as transparency levels decline. The issue has been studied in great detail with reference to the Otc bond market (Green et al., 2008) and the corporate bond market (Bessembinder et al., 2006).

Other contributions move a step forward extending the analysis to the investor behavior. Here, the main idea is that liquidity constraints and differing holding periods may affect portfolio behavior of agents. Accounting for a clientele effect assumes particular importance allowing to represent portfolio choices as a matrix in which heterogeneity of agents becomes an important variable in explaining investor behavior. Some interesting findings account for a risk sharing behavior over time which appears to be coherent with some well-known puzzles, for example, those accounting for a limited participation of households in the securities markets (Mankiw and Zeldes, 1991). Other studies (Longstaff, 2004) find that heterogeneous agents chose highly polarized portfolios when facing illiquidity conditions, with short-term-horizon agents focusing primarily on risky assets and long-term-horizon investors finding it optimal to specialize in safer assets, whereas traditional asset pricing theory claims for the optimality of the diversification of investors' holdings.

Most literature focuses on liquidity costs and liquidity premium in stocks; there is also a growing number of contributions dealing with bonds. Assets with higher bid-ask spreads (that can be assumed as a measure of liquidity premium) would be allocated to portfolios with longer expected holding periods (Amihud and Mendelson, 1986). Now, as risk premium increases, the widening of the spreads turns out in increasing disinvestment costs.

Some contributions studied the effects of the liquidity on the pricing with reference to the corporate bonds. However, it does not appear to be an easy task to decompose the spreads on corporate bonds in terms of the components related to the default risk versus other factors. For instance, it has been demonstrated (Huang and Huang, 2003) how most structural models are only able to explain half of corporate bond spreads.

Other works (Hördahl and Packer, 2007) deal in great detail with a review of analytical contributions on asset prices and their determinants. In particular, the determinants of the credit spreads compared with free risk securities have been studied. Empirical evidence shows how the expected losses explain a limited part of the credit spreads. As known, this phenomenon is referred to as the *credit spread puzzle* (D'Amato and Remolona 2003).

The premium for the liquidity is one of the attributes, besides the expected losses, taken into consideration in order to explain the credit spreads, although the theoretical literature and the empirical research do not turned out with univocal results with respect to the relative importance of the various factors. In fact, empirical research on the determinants of credit spreads delivers uncertain results. Guazzarotti (2004) examines the determinants of variations in *credit spreads* on a portfolio of non-financial institutions' corporate bonds during the period of 1999-2003. According to his findings, *default risk* explains 20% of volatility in *credit spreads* whereas liquidity and other market factors explain another 10%.

Other research contributions examine the determinants of corporate bonds *spreads*. For example, the Federal Reserve Bank of San Francisco (2004), analyzes the determinants of spreads on *high yield* corporate bonds showing an interesting liquidity effect; in particular, a tight relation emerges between liquidity conditions, economic cycle and monetary policy decisions. During the 2001 recession a widening in *high yield bond* spreads was observed, followed by a subsequent convergence due to a more relaxed monetary policy, which resulted in better liquidity conditions.

The extension of the phenomenon appears to differ across different types of investors. Some papers (among the others see Harris and Piwowar, forthcoming), show how the costs of trading differ considerably between professional or retail investors, with the latter mainly affected by the phenomenon.

2. Selling illiquid financial products: a new approach

The less expert investor is not, generally, in a position to perceive the liquidity risks and associated costs. Drawing on the Mifid framework, Consob, the Italian supervisory authority, recently delivered level III measures entailing a new approach in distributing certain illiquid products to retail clients based on a more far reaching disclosure and fair commercial practices. The disclosure policy should be aimed at granting the investor all the relevant information about a financial instrument both when proposing the investment (ex ante transparency) and after having executed it (ex post transparency). Within the framework emerging from Mifid and supervisors' guidelines, transparency is one of the three pillars of regulation, the other two being fair practices and risk management.

Given the uncertainty in identifying the features of an illiquid financial product there is the risk that the intermediaries determine in a not homogeneous way

the sphere of rules' application. Recently, the Italian Banking Association delivered guidelines to the banks in which it identified certain types of financial products deemed to potentially bear illiquidity risk (i.e. senior bonds, subordinated bonds, other debt securities, Otc derivatives, covered warrants, certificates, certain insurance products such as index linked and unit linked). However, it is obvious that the classification of a product as illiquid necessarily presupposes a case by case evaluation founded on the specific characteristics of the issuer, the product and the market where it can be, eventually, traded. The compliance with the new regulations requires the intermediary to periodically assess, upon objective criteria, the degree of liquidity in relation to the financial products distributed to the client and eventually upgrade their classification.

As reference, it could be deemed to be liquid an instrument for which a regulated market or Mtf exists, especially when there is at least a market maker (or specialist) that commits to expose in a continuous manner buy and sell orders. Otherwise, there could be a systematic internalizer (the same intermediary issuing or placing the instrument or other intermediary) who satisfies certain minimum criteria as for spreads, minimum quantities for each order and transparency. Liquidity may also be granted by the issuing, placing or other intermediary which, at the issue of the product, committed itself to buy it on the secondary market. Obviously, in this case the pricing should be determined according to objective criteria defined in advance and explained in the commitment. When it is the issuing intermediary to commit itself, the right to sell should be granted to all the investors. When the commitment is made by one or more placing intermediaries (or it is another intermediary to commit itself) the right should be granted only to those investors who subscribed the product with the committing intermediary.

Moreover, there could be the temptation to identify complex products with risky products as emerges from a systematic reading of Consob level III measures. This choice may appear misleading for certain products which guarantee the capital invested. Here the risk is to impose unnecessary tight compliance burdens for products which do not entail particular risks of loosing invested capital.

The transparency issue although intuitive is not easy to define. It is not just a matter of disclosing prices and costs but claims for a more broader representation of risks and potential performances based on given market scenarios. Moreover, it turns to be an organizational issue since it encompasses methodologies and procedures which should be deemed to be comprised in a disclosure policy and

involve a reporting strategy. The implications of disclosure go far beyond the relationship with the client and cover the compliance function of the intermediary and the entire management.

Formally, the intermediary should comply with disclosure duties when offering the product, when, eventually, negotiating the same after the placement and in the periodic reporting to the client.

When placing the product the intermediary may comply with disclosure policy including in the prospectus clear, unambiguous and immediately comprehensible information concerning prices, costs and risks inherent to the specific product purchased or, otherwise, using a synthetic document containing complete and easy to understand information about the product.

What is really innovative in Consob level III measures is the content of the disclosure policy which should include information that the retail client, normally, does not use to deal with. In particular, the indication of fair value (both when placing the product and in periodic reporting) gathers information which the client may not be able to properly understand. Some remarks should be made about *fair value measurement*. Consob guidelines adhere to the principles of Ias fair value evaluations, assuring coherence between evaluations for accounting purposes and those used in negotiations with clients. However, this would imply some criticalities, in particular, market scenarios of scarce liquidity. Recently, Cesr (2008) issued a Consultation document containing guidelines on fair value measurement and related disclosures of financial instruments in illiquid markets whereas Bank for International Settlements (2008b) carried out an assessment of challenges posed by fair value modeling. Here it is stressed how the main challenges stem from the absence of active and liquid markets for some products and the complexity of the payoff structures.

Above all, for certain bonds with one or more derivatives embedded, the intermediary should be deemed to proceed with the unbundling of all the items defining the total disbursement, that is to say the bond value, that of the derivatives items and costs charged to the customer. In a context of informative asymmetries the separate exposition of costs charged to the customer permits at least to appreciate the part of the total disbursement deriving from the investment and the fraction that, instead, represents the remuneration for the intermediary. Moreover, it improves the perception of liquidity risk evidencing the losses which the customer may incur in case of liquidation as an effect of such costs. For certain structured products the opacity of the

structure is an important source of immediate economic returns for intermediaries in terms of upfront and *mark-ups* (structuring costs, placement costs) which are not immediately visible for the client. Obviously, Consob recommends an ex ante transparency conducted operation by operation. From the commercial point of view the unbundling of the position would render more difficulties for the intermediary to justify high charges. Italian Banking Association, in particular, objects that it would be difficult for the client to understand all detailed information about price and costs. It could be answered, however, what is more misleading for the client, a great transparency or, otherwise, the habit to bundle all the relevant elements that contribute to the total disbursement.

Some peculiarities are, then, entailed for certain Otc derivatives for which the client may not be able to understand the functioning. Here, apart from the fair value measurement and the disclosure of costs (comprised hedging costs) and *mark-ups*, it may be useful for the client to receive information about the past trends of the parameters affecting the derivative's value (for example, certain interest rates) and an illustration of expected pay-offs at maturity. It could be asked if the client would be able to understand and properly assess such information.

Given the features of certain financial products such as structured bonds, certificates, covered warrants or Otc derivatives, the main problems for the investor are the proper risk assessment and the conditions at which he can liquidate the investment.

For the purposes of a proper risk assessment Consob guidelines appear to be innovative as far as these guidelines entrust to the scenario analysis the understanding of the effects, on the value of the investment, deriving from the evolution of market conditions.

This would entail the application of quantitative methods explaining the sensitivity of financial products to the various risk factors. The scenario analysis is not foreseen in the discipline of the prospectus. In the praxis, however, in relation to structured bonds intermediaries already supply exemplifications on the yields even if not on probabilistic bases. The presence of embedded derivatives in several structures makes uncertain the distribution of the pay offs according to the different market scenarios. Moreover, also plain vanilla instruments, in certain market scenarios, can expose the investor to remarkable risks of loss. It is to note, however, that the transparency requirements imposed by the Consob, in particular those referring to the scenario analysis, may turn to be an obstacle

for the bank wishing to raise funds. Should the bank report a high probability to incur losses, it is doubtful that the retail client want to buy that product.

Note that Consob has already foreseen in her regulation the provision of a synthetic indicator of risk for non equity products in a scale of six classes (low, medium-low, medium, medium-high, high, very high). Recently, Consob (2009) proposed a GARCH based approach drawing on Geweke (1986) model in order to identify volatility ranges for each class (See also Duan (1997)). This approach, moreover, could help to identify and disclose to the client successive migrations to other classes of risk. In this field new developments emerge which are related to the use of transparency metrics on risks for helping the intermediary to better understand the most appropriate holding period for the client and recommend the products which best fit that time horizon. The use of models for the risk management purposes could be extended to support the suitability test and investment advices to clients. Moreover, identifying the most suitable holding period could help the intermediary to better define the time horizon for the scenario analysis.

As for the liquidation of the investment, Consob guidelines entrust the intermediaries with the duty to disclose the presumable liquidation value, in a time immediately after the placement but also in periodic reports, which is meant as ask price to the gross of eventual commissions that the customer would pay during negotiation. However, the main criticalities are related to the trading venues where the financial product could be sold. There is no doubt that the intermediary should be deemed to disclose the trading venues where to deliver the order. However, in most cases the only source of liquidity is the intermediary who issued or placed the product (for example, in Otc derivatives) or another intermediary who committed itself to buy the product or, otherwise, a liquidity provider. Obviously, for bonds or certificates the problem are the spreads on the selected trading venues which, however, for certain products may turn to be wide and highly volatile. Drawing on Consob guidelines, recently the Italian Banking Association recommended Italian banks to show in the disclosure policy the average spreads on the selected venue. When the intermediary is the only source of liquidity, it is likely that the intermediary would disclose the methodologies in determining the spreads, or, in case of Otc derivatives, those used in the determination of the liquidating value.

On balance, it should be observed that a full transparency could be useful to the customer as control element on the conduct of the intermediary.

By contrast, banks object that it would be turn out to an excessive burden, a complete transparency over fair value and the likely disinvestments value. Really, the disclosure obligations which the intermediaries are recommended to comply to are based on assumptions necessarily subject to simplifications regarding, for example, the measurement of the fair value and the presumable value of disinvestment. The latter not only depends on the market scenario but also on the conditions that the intermediary applies and that, within the normal commercial policies, varies from customer to customer according to the objectives of the same intermediary and the risk associated with the customer.

More problematic, instead, is the use of information received in order to take a choice among different intermediaries, considering the substantial level of personalization of several products. Really, but on a different level, the Consob guidelines recommend a comparison between the specific product placed to the customer and simple products, well known, liquid and with a low risk, that could be regarded as alternative investments. Moreover, such comparison is seen as useful support to the customer in order to correctly evaluate costs and risks of the instrument in relation to well known products and with which the customer has familiarity. In this regard, Consob guidelines seem to introduce some margins of uncertainty. The reference to alternative products widely used in the market is stranger to the actual normative framework and it innovates under the profile of the operating praxes of the intermediary. The proper choice of the benchmark appears to be essential; we could ask ourselves about the consequences deriving from choosing an unsuitable benchmark and, in particular, if the customer can object, during litigation, an unsuitable choice such as to lead him to an improper assessment of risks.

3. New challenges for the financial industry in Europe

The Italian supervisory authority guidelines remarkably strengthen the disclosure requirements for intermediaries. Those measures entail a substantial change in the operating philosophies of the intermediaries and induce some considerations regarding financial intermediation within the Mifid framework. A wide range information can turn out of a certain usefulness only on the condition that the customer is in a position to appreciate the information and take an aware decision. Under conditions of limited rationality the availability of a wide informative set could not turn out sufficient for the investor. Important is the role of the intermediary which will have to assume an active role of

customer's guide in selecting the better investment alternatives.

Intermediaries are expected to bear more extensive responsibilities when dealing with less expert investors in relation to certain less liquid risky assets. A new attitude in understanding client's needs and proposing the solutions that best fit its profile is required.

When placing certain illiquid products the intermediary will be held to proceed unavoidably to a suitability test. This is particularly true for certain structured products. The structuring process, in fact, by definition leads to the construction of a product "tailored" for the customer and presented as suitable for the same one. This implies the supply of an advisory service according to the Mifid directive. It is obvious that the intermediary should acknowledge that the investor is aware of the risks and the distribution of expected pay-offs.

What should be avoided is a dogmatic approach. In this regard, the Consultation document delivered by Consob appeared to be more strict in assuming in advance that investment in illiquid products is unsuitable for the typical retail client. As a matter of fact, this would have prevented intermediaries from operating with these instruments.

More generally, the issue arises which kind of intermediation model we want. In fact, the risk is to give rise to somewhat paradoxical outcomes where the intent of protecting the client would move away the risk adverse investors from investment products that are more suitable according to their own profile (such as those guarantying the capital). Similar considerations could be drawn for riskier products. Investor protection, avoiding *miss-selling* practices, doesn't imply to avoid selling risky assets at all. Having the rules but not the market would not be the best outcome for European securities industry. Following objections from intermediaries' associations Consob eliminated any reference to the retail client permitting intermediaries to sell illiquid instruments to those clients upon acknowledgement, on a case-by-case basis, of the comprehension of risks.

What is important is to assure objectivity and fairness in determining economic conditions applied to the customers as to pricing, commissions and *mark-ups* and to specifically assess the coherence of the proposed investment with the client's objectives. To this end, the intermediary should be deemed to specifically assess costs entailed by the investment and holding period. It has to be noted that costs do not constitute a specific parameter for the suitability test, according to the Mifid. However, liquidation costs are direct manifestation of the liquidity risk

even if, often, the investor does not have a clear perception of those costs. In specie, it turns out obvious as the potential dynamics of the bid-ask spread must be object of specific evaluation. It goes, moreover, reminded that also a capital protective product as well, if disinvested before the maturity, can imply losses for the customer. Consequently, the holding period has to be specifically assessed as well and put in relation with the characteristics of duration and liquidity of the proposed investment. As Consob observed, a synthetic suitability test in which the holding period is not distinguished from other profiles would deliver a misleading perception of the liquidity risk. In principle, an operation with illiquid instruments will be unsuitable for those retail customers that have a holding period lower than the duration of the instrument. The Consob, moreover, moderates such presumption in case the intermediary gets a process of suitability evaluation that concurs to consider the degree of illiquidity of the products. The gap between holding period and duration will tend to be less relevant as much as greater will be the degree of liquidity of the product.

It is obvious that the intermediary in assessing the liquidity of the investment should take into consideration the conditions in which he will eventually liquidate the position (considering the commitment of another intermediary to buy it). On the secondary market, the investor could send the selling order to the same intermediary who issued, placed or distributed the product or, otherwise, to another intermediary. In any case, the intermediary receiving the order should adopt an execution (transmission) policy in order to comply with best execution duties.

However, the duty to deliver best execution turns out to be difficult in relation to illiquid financial products for which Mifid assumption on the existence of a variety of trading venues doesn't hold. For this reason, a research of the best possible conditions for products lacking a liquid market can appear a logical loop. As a matter of fact, in most cases the only source of liquidity is the intermediary receiving the order who acts as an internalizer (systematic or not) or otherwise commits itself to buy the instrument. In such cases, the responsibilities of the intermediary are far reaching since it has to adopt objective pricing methods and such methods should unavoidably be considered as a parameter for best execution.

The pricing is often based on the application of internal models that could subtend opportunistic behaviors. The need to make the process more objective would suggest to resort to external parameters of evaluation. The absence of efficient markets for several products would imply, however,

the demand for quotations to third parties, as market makers or systematic internalizers. In its Consultation document, Consob laid down an obligation for the intermediary to request other parties for quotations in case of financial instruments not traded on regulated markets or Mtf's. With this Consob seemed to presume that financial instruments traded on these platforms should be considered as liquid.

This proposes the well-known debate over benchmarking for best execution duties in the distribution of structured financial products which accompanied discussions on Mifid adoption. Such a solution bears several evident applicative difficulties. Apart from the potential conflicts of interests on the topic between various securities industry operators, the requirement appears to weaken from a practical point of view. The problem seems to emerge above all for branded products in relation to which the intermediary is both issuer and distributor. In this case, it is doubtful that a market maker or systematic internalizer could judge convenient to produce quotations and to supply liquidity on products structured and issued from other intermediary. In the delineated context, the obligation imposed by the Consob is shaped, therefore, as an engagement of the intermediary to guarantee professionalism, producing every reasonable effort to find external informative sources. The unfruitful search for quotations produced by third parties does not prevent the possibility to conclude the operation; it will be responsibility of the intermediary to assess whether or not to deal with retail customers relying only on the price resulting from the model.

However, should an intermediary exist who committed itself to buy the instrument or otherwise acting as liquidity provider, it have to be considered in the execution (transmission) policy of the intermediary receiving the order. The latter bears no responsibility as regards the pricing. There is no doubt, however, that he should assess the coherence of pricing methods adopted by the committing intermediary with those included in advance in the committing policies or make sure that the liquidity provider adopts objective pricing methods coherent with Consob recommendations.

A systematic evaluation of the Consob disclosure rules claims for a redefinition of the relationships in the securities industry. On one hand, this would imply an increase in costs of compliance for the intermediaries and a minor discretion in their commercial policies. However, intermediaries could

exploit scope economies by extending the models they use for risk management purposes to comply with transparency obligations. On the other hand, these rules stretch to reduce the exposure of the investor (yet asset managers) to opportunistic behaviors of the intermediaries. From a substantial point of view, an effective disclosure about prices and costs would supply the customer with both the essential elements in order to properly assess risks and expected returns of the proposed operations and the bases for a more objective assessment of the intermediary in complying with the duty of best execution. On such a level, however, a substantial tradeoff between investor's need of protection and intermediaries commercial policies finds manifestation. The possible approaches go from a detailed regulation to a valorization of the company autonomy based on clear procedures that govern and discipline price formation and communication policies to the customer. It is clear that the definition of the disclosure policy encompasses the responsibility of the entire management. For products placed or in relation to which the intermediary deals on own account the policy should be approved by the board of directors. At least, such policy should foresee all relevant factors to be used in pricing models as input (curve rates, spreads, share prices, index prices). As for *mark-ups* the policy should be deemed to foresee the organizational units within the company entrusted to define their value and the variables employed.

Conclusions

The investment in illiquid financial products presupposes, in a context in which intermediaries should comply with a duty to serve at best the interest of their clients, adequate forms of protection in favor of the weaker contractor. High standards of disclosure, moreover, do not appear sufficient to the scope. The limited rationality of the investor, particularly the retail one, emphasizes the dependency on the professionalism of the intermediary. This is true particularly in the sphere, with uncertain borders, of illiquid financial products, where the evaluation parameters turn out remarkably more complicated. The debate opened in Italy about the level 3 measures adopted by the Consob stressed the difficulty to find an equilibrium between the need of protection for less expert investor and effectiveness of the commercial policies within the financial industry. It is certain that financial institutions will have to renounce important rents that, until now, are derived from the opacity of the distribution of certain products.

References

1. Amihud Y., H. Mendelson (1986). Asset pricing and the bid ask spread, *Journal of Financial Economics*, Vol. 17, No. 2.

2. Bank for International Settlements. Customer suitability in the retail sale of financial products and services // Technical Report, Apr. 2008.
3. Bank for International Settlements. Fair value measurement and modelling: an assessment of challenges and lessons learned from the market stress // Technical Report, June 2008.
4. Bessembinder H., W.F. Maxwell, K. Venkataraman (2006). Market transparency, liquidity externalities and institutional trading costs in corporate bonds, *Journal of Financial Economics*, Vol. 82, No. 2.
5. Cesr (2008). Fair value measurement and related disclosures of financial instruments in illiquid markets, Draft statement, No. 08-437.
6. Consob (2009). Un approccio quantitative risk based per la trasparenza dei prodotti d'investimento non equity, *Quaderno di Finanza*, No. 43.
7. D'Amato J., E. Remolona (2003). The credit spread puzzle, *Bis Quarterly Review*.
8. Duan J.C. (1997). Augmented GARCH (p,q) process and its diffusion limits, *Journal of Econometrics*, Vol. 79, No. 1.
9. Federal Reserve Bank of San Francisco (2004). What determines the credit spreads?, *Economic Letter*, No. 36.
10. Geweke J. (1986). Modelling the persistence of conditional variances: a comment, *Econometric Review*, Vol. 5, No 1.
11. Green R.C., D. Li, N. Schurhoff (2008). Price discovery in illiquid markets, *Working Paper*, Carnegie Mellon University.
12. Guazzarotti G. The Determinants of changes in credit spreads of European corporate bonds // Bank of Italy, 2004. – Mimeo.
13. Harris L., M. Piowar. Municipal Bond Liquidity, *Journal of Finance*, submitted for publication.
14. Hördahl P., F. Packer (2007). Understanding asset prices: an overview, *Bis Papers*, No. 34.
15. Huang J., M. Huang (2003). How much of the corporate yield spread is due to credit risk?, *14th Annual Conference on Financial Economics and Accounting*.
16. Longstaff F.A. Financial Claustrophobia: asset pricing in illiquid markets // Nber Working Paper, 2004.
17. Mankiw N., S. Zeldes (1991). The consumption of shareholders and non-shareholders, *Journal of Financial Economics*, Vol. 29, No. 1.