

Illiquid Financial products and distribution policies: new insights

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Abstract

Both changing investors' behaviour and contingent events, such as financial crisis, stimulated a debate around the distribution of financial products for which an active market doesn't exist. Investing in illiquid financial instruments requires a certain degree of financial education in order to properly understand all the risks entailed by the investment. Less expert investors lack the basic tools for evaluating more complex structures and liquidity costs; this, in turn, leaves room for opportunistic behaviours by intermediaries. New regulations are targeted to improve risk-based transparency standards and set tighter conduct of business rules for intermediaries' commercial policies. Nevertheless, some important issues still remain on the desk requiring better insight. Conceptually, more transparency surely would benefit investors. However bounded rationality would impede less expert investors to properly understand all the information provided. The question we want to address deals with the effectiveness of a risk based transparency regulation.

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1 Introduction

When investing in financial instruments the investor faces a risk of opportunistic behaviour by the intermediary, along with the risks which are inherent to the specific features of the product. The magnitude of the former obviously differs across investors and types of investments. Both information asymmetries and limited rationality affects less expert investors to a greater extent than professional investors. The former are, therefore, exposed to risks of *miss-selling* practices. In the meantime, recent evidences demonstrate that intermediaries' behaviour raises particular concerns for those financial products for which an active market doesn't exist. For so called illiquid financial products the risk of *miss-selling* practices is greater. In fact, in such circumstances the intermediary may have the incentive to exploit superior information for raising profits at the expense of the client. This claims for tighter conduct of business rules for intermediaries.

A condition of illiquidity may arise due to inherent characteristics of the product or factual circumstances. Accordingly, a financial product would be illiquid as a transparent and orderly 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. Several instruments negotiated on regulated markets are characterized for limited levels of liquidity as well. Moreover, during a financial turmoil which dries up liquidity, the same instruments that normally have an active market can become illiquid.

Most recent regulatory frameworks seek remedies for better aligning the intermediaries' behaviour to the client's interest, claiming 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 identify the risks entailed by an illiquid investment which may affect portfolio choices, according to the different characteristics of the investor. Then we address the remedies entailed by most recent regulations. 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 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 behaviour of investors.

The work is organized as follows. In paragraph 2 we will address the liquidity issue and its implications for retail customers. In paragraph 3 we will discuss the main issues related to the regulation of intermediaries' behaviour in distributing illiquid financial products to retail clients. In paragraph 4 we will discuss the main challenges for the financial industry. Paragraph 5 concludes.

2 Liquidity constraints and investor behaviour

For certain financial products the intermediary may have a clear incentive to behave in an unfair manner recommending and placing products with potentially high profitability and immediate economic returns. This is particularly true for those products for which the intermediary acts both as issuer and distributor.

It is, for example, the case of certain structured finance products which are source of considerable upfront commissions and *mark-ups* for banks, but also

certain banking bonds, often highly illiquid, which permit the intermediary to resolve funding problems. In such cases, the presence of relevant conflicts of interest may prevent the intermediary from complying with the duty of best serving the client's interest. Less expert investors generally lack the required skills for properly evaluating all the risks entailed by an investment; nevertheless the fraction of their wealth allocated to assets entailing some liquidity risk is growing. Although intermediaries are deemed to devote great efforts to understand the client's profile and its attitude toward risk and to disclose all relevant information for a proper investment decision, they not always comply with such duties. Generally, intermediaries are not so prone to disclose important pieces of information to the client, in particular those referring to conflicts of interest, risks and costs, both direct and indirect (Bank for International Settlements, [2]). This is why disclosure policies appear to be of particular relevance.

In fragmented, decentralized and opaque markets lack of transparency may:

- a) undermine the price discovery process involving high transaction costs and widening spreads;
- b) affect the investor's behaviour, entailing a clientele effect..

A wide field of research accounts for a strict relation between trading costs and transparency, with costs becoming as higher as transparency levels decline [4, 10]. In the meantime, the heterogeneity of agents allows for differing portfolio choices according to differing degrees of liquidity and investors' holding periods. Longstaff [15] finds 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 investor's holdings.

On the other end it has been argued that 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 [1]. Now, as risk premium increases, the widening of spreads turns out in increasing disinvestment costs.

Some theoretical and empirical research studied the contribution of liquidity on corporate bonds' spreads. The decomposition of spreads on corporate bonds is not an easy task [14]; nevertheless some works (see [13]) deal in great detail with a review of analytical contributions on asset..

The premium for the liquidity is one of the attributes, besides the expected losses, taken into consideration in order to explain the credit spreads. However, empirical research on the determinants of credit spreads delivers uncertain results. There are evidences (among other, see [6]) showing how the expected losses explain a limited part of the credit spreads. As known, this phenomena is referred to as the *credit spread puzzle*. Liquidity premiums are among the attributes which may explain the credit spreads. The extension of the phenomena appears to differ across different types of investor. Some papers [12] show how the costs of trading differ considerably across different types of investors, with retail investors mainly affected by the phenomenon.

Guazzarotti [11] examines the determinants of variations in *credit spreads* on a portfolio of non financial institutions' corporate bonds during the period 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 account for a tight relation 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 (see Federal Reserve Bank of San Francisco [8]).

3 Improving the regulatory framework for illiquid investments

Less expert investors are not, generally, in the position to perceive neither the risks entailed by certain financial products for which an active market doesn't exist (but it is also the case of certain instruments traded in organized markets as well such as certain small cap stocks or bonds) nor the uncertainty of pay offs.

In Europe new pieces of legislation emerged dealing with the need of better aligning intermediaries' behaviour with client's interests. In particular the "Markets in financial instruments directive" (Mifid) envisages tight conduct of business rules for intermediaries providing financial services to clients. For illiquid financial products distributed to retail investors, intermediaries should be deemed to comply with tighter rules. However, the uncertainty in defining the features of an illiquid financial product there is the risk that the intermediaries determine in a not homogenous way the sphere of application. In any case, 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. What it should be avoided is the temptation to identify complex products with risky products. This would be misleading for certain products which include the guarantee for the capital invested, imposing unnecessary tight compliance burdens for products which not entail particular risks.

Within the European Mifid framework the measures entrusted by certain national supervisors envisage an approach for the distribution of illiquid financial products based on three pillars:

- a) Transparency;
- b) Fair practices;
- c) Risk management.

The disclosure policy should be focused both on an ex ante transparency (when proposing the investment) and an ex post transparency (after having executed the investment).

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 internaliser (the same intermediary issuing or placing the instrument or other intermediaries) 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 commits itself to buy it on the secondary market. Obviously, in this case the pricing should be determined according to objective criteria defined and explained in advance. 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.

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. Formally, the intermediary should comply with disclosure duties when offering the product or, eventually, negotiating the same after the placement and in the periodic reporting to the client. When placing the product the intermediary may comply with a 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, is not used 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 [5] issued a Consultation document containing guidelines on fair value measurement and related disclosures for financial instruments in illiquid markets whereas the Bank for International Settlements [3] carried out an assessment of challenges posed by fair value modelling. 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 contributing to 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 information asymmetries the separate exposition of costs charged to the customer permit 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 the 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. Under a commercial point of view the unbundling of the position would render more difficult for the intermediary to justify high charges. Italian Banking Association, in particular, object that it would be difficult for the client to understand all detailed information about prices 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 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 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.

As regards 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 pay offs according with the

different market scenarios. Moreover, also plain vanilla instruments, in certain conditions, 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 an high probability to incur losses, it is doubtful that the retail client want to buy that product.

Note that Consob have 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). The Italian supervisory commission proposed a GARCH based approach drawing on Geweke [9] model in order to identify volatility ranges for each class. This approach, moreover, could help to identify and disclose further 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 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 immediately after the placement but also in periodic reports. Such a price is meant as the 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. For

bonds or certificates relevant criticalities may arise with spreads on the selected trading venues which 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 a complete transparency over fair value would result to an excessive burden. Really, the disclosure obligation which the intermediaries are recommended to comply to are based on assumptions necessarily subject to simplifications regarding, as an example, the measurement of the fair value and the presumable value of disinvestment. The latter not only depends from the market scenario but also from the conditions that the intermediary applies and that, within the normal commercial policies, varies from customer to customer according with the objectives of the same intermediary and the risk associated to the customer.

More problematic it appears, instead, the use of information received in order to choose 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 well known simple products, which are liquid and with a low risk, that could be regarded as alternative investments. Moreover, such comparison is seen as a 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. At this regard, Consob guidelines seem to introduce some margins of uncertainty. The reference to alternative products widely used in the market is unknown in the current 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.

4 The distribution of illiquid financial products: the need for a new approach

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 of information may help the customer to take an aware decision at the condition that he really appreciates it and properly understands all the implications. In conditions of limited rationality the availability of a wide informative set could not turn out sufficient for the investor. In such circumstances the intermediary is expected to assume an active role in guiding the customer in the selection of 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 obliged 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 about the risks and the distribution of expected pay-offs.

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

More generally, the issue regards 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 implies to avoid selling risky assets at all. Having the rules but not the market would not be the best outcome for European securities industry.

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 asses the costs entailed by the investment and the holding period. It has to be noted that costs doesn't 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. It is obvious that the potential dynamics of the bid-ask spread must be object of specific evaluation. Moreover, it should be reminded that also a capital protective product, if disinvested before the maturity, may 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. As principle, an operation in illiquid instruments will be unsuitable for those retail customers that have an holding period lower than the duration of the instrument. The Consob, moreover, weakened such presumption provided that the intermediary undergoes a suitability evaluation that considers 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 at 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 the 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 matter of fact, in most cases the only source of liquidity is the intermediary receiving the order who acts as an internaliser (systematic or not) or otherwise commits itself to buy the instrument. In such cases, the responsibilities of the intermediary are far reaching since it have 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 entail opportunistic behaviours. The need to make more objective the process 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 internalisers. 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. Therefore, 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 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 internaliser could judge convenient to produce quotations and to supply liquidity on products structured and issued from other intermediary. In this context, the obligation imposed by the Consob is shaped, therefore, as engagement of the intermediary to guarantee professionalism, producing every reasonable effort to the aim of finding external informative sources. The unfruitful search for quotations produced by third parties do not prevent the possibility to conclude the operation; it will be responsibility of the intermediary to assess whether to conclude or not the 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 the 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 another point of view, an effective disclosure about prices and costs would supply the customer both the main elements in order to properly assess risks and expected returns of the proposed investment and the bases for a more objective assessment of the intermediary's ability in complying with the duty of best execution. On such a level, however, a substantial trade-off between investor's need of protection and intermediaries commercial policies finds manifestation. The possible approaches range from a detailed regulation to the promotion of the intermediary's 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.

5 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 to the professionalism of the intermediary. This is true particularly into the sphere, with uncertain borders, of illiquid financial products, where the evaluation parameters turns 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 to important rents that, until now, derived from the opacity of certain products.

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