Guidelines for the application of the CONSOB level 3 measures on illiquid financial products

Approved by CONSOB on
5th August 2009

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Foreword

This document provides useful guidelines regarding the implementation of CONSOB Notice No. 9019104, dated 2 March 2009 (hereinafter, the 'Notice') in compliance with CONSOB's Policy on approving Guidelines, dated 2 May 2008, and the content of the official CONSOB letter dated 6 March 2009, thanks to which CONSOB made itself available to open talks with the Associations on approving Guidelines. These Guidelines are suitable for supporting the intermediaries with further clear details and explanations of the Notice.

The document has been drawn up by the intermediary trade associations (ABI - Italian Banking Association, Federcasse - Italian Association of Cooperative Banks, and Assosim - Italian Association of Financial Intermediaries, hereinafter the Associations) with the aim of identifying technical solutions which represent a safe harbour in terms of correct application by the intermediaries, whilst observing their decision-making autonomy when defining business models and organizational set-ups.

Relevant legislative framework

The Guidelines are set within a legislative framework defined by tier-one and tier-two rules for the implementation of the MiFID, taking into account the detailed interpretation recommendations provided by CONSOB (see CONSOB Notice No. 9019104 dated 2 March 2009) regarding the distribution of financial products, to retail clients, for which there are problems in disinvesting at meaningful price conditions[1] and reasonable time frame.

CONSOB's initiative is motivated by the framework of significant information (i.e. disclosure, *Ed.*) asymmetry on illiquid products in the relationship between intermediaries and retail clients. This initiative aims to lay out specific transparency and fairness criteria, consistently with the relevant duties that intermediaries have to comply with when providing investment services.

In line with the new MiFID regulations, even when placing illiquid financial products, intermediaries have to act as service providers, as opposed to mere product sellers, considering the lasting relationship with the client which has an underlying agreement providing investment services. In this respect, transparency and fairness safeguards – as per the CONSOB Notice – aim to bridge the information gap between intermediaries and their clients, leading intermediaries to adopt practices aimed at safeguarding investors' interests as fully as possible.

In other words, by guiding the intermediaries' entire organizational structure to observe legislative requirements and, consequently, preparing safeguards for compliance with the due practices of a general nature, the recommendations

[1] Meaningful price conditions are intended as conditions such as to reflect, directly or indirectly, a plurality of interests on buying and selling.

provided by CONSOB in the Notice represent specific behavioural guidelines in cases where intermediaries distribute financial products with a limited degree of liquidity to retail clients, within the framework of the services defined further on.

The central role an intermediary plays in dealing with clients justifies imposing specific behavioural safeguards for products with a limited degree of liquidity. As it emerges in the Notice, the measures therein envisaged affect, to a different extent, the following investment services and activities:

a) sale of financial instruments and products at issuance. Namely, the distribution of banks' own issued products, the placement of products issued by third parties (including entities belonging to the same group), as well as the distribution of insurance products with financial content;
b) proprietary trading;
c) executing orders on behalf of clients and accepting/transmitting orders; and
d) providing investment advice, also in association with the services and activities indicated above.

More specifically, rules and interpretations on financial instrument pricing are based on quite separate and different procedures: directly, where issuers and/or traders take care of the distribution on their own account, and indirectly – and as an appraisal of third party's pricing – when providing placement services for financial instruments issued by third parties, executing, or accepting-transmitting orders, in accordance with the procedures and criteria envisaged in the order execution and transmission policy. It follows that, when defining transmission strategies, intermediaries providing the order acceptance and transmission services will have to ensure – in compliance with and within the limits of sections 4.8.1. and 4.8.2. of this document – that the rules of organisation adopted by the traders to whom they transmit the orders are such as to ensure compliance with the best execution principle.

Similarly, the transparency measures set in the Notice have a different effect as regards intensity depending on the activities and services provided to clients. In particular, with regard to execution, acceptance and transmission of orders, the recommendations on ex-ante transparency are meant to be interpreted in a less strict manner and according to methods which usually presuppose an assessment of the detailed information on a security to the extent that this is made available either by the issuer, the placer, the trader acting on its own account or by the relevant execution venue.

The products the Notice refers to are identified by CONSOB as those which "*give rise to obstacles or limitations* (for the investor) *when disinvesting within* a *reasonable period of time, at meaningful price conditions, i.e. conditions such* as *to reflect, directly or indirectly, a plurality of interests on buying and selling*[2]", also

[2] See the Notice, "Sphere of application of the level 3 guidelines", page 4, second paragraph.

bearing in mind a transaction's economic convenience considering the costs an investor may have to bear[3].
The liquidity or illiquidity of a financial product has to be considered as a factual condition, rather than a characteristic of its mere legal status. Consequently, it is the existence – and the related degree – of certain conditions which qualify the level of liquidity of a product.

Introduction to the Guidelines

A proper implementation of the Guidelines means that, in defining the correct commercial policy[4], intermediaries should take steps to evaluate the compatibility of each instrument included in the product catalogue with the characteristics and needs of the clients they plan to offer them to, bearing in mind the products' general form.

In detail, the intermediaries' corporate policies and processes should theoretically facilitate the assessment of the financial requirements the products on offer will have to satisfy, as well as guide the creation of incentive mechanisms for the corporate structure, as per criteria not in contrast with the pursuit of the client's best interest.

The structure and contents of the Guidelines illustrate:

a) the features and conditions affecting the valuation of the liquidity of financial instruments and products, which the intermediary is obliged to verify over time, bearing in mind the potentially dynamic nature of a product's liquidity/illiquidity (chapter 1);

b) the criteria to be adopted for appropriateness and/or suitability test (chapter 2);

c) the monitoring rules in the event of OTC derivatives used for hedging purposes (chapter 3);

d) organisational rules on pricing (chapter 4);

e) *ex-ante* and *ex-post* disclosure safeguards (chapter 5); and

f) the timescale for procedural updates (chapter 6).

[3] See the Notice page 4, and note 8 of the document "Outcome of the consultation" issued by CONSOB simultaneously with the Notice.
[4] See the Notice page 5.

Section 1 - Criteria for the identification of liquid financial products

These Guidelines refer to the financial instruments and products listed in the table below, being the most common and characterised by potential illiquidity:

Classes of financial products	Type of product
Debt securities	Senior bonds
	Subordinated bonds
	Other debt securities
Derivative financial instruments	OTC derivatives[5]
	Covered Warrants
	Certificates
	Other derivative instruments
Insurance products with financial content	Life Class III (Italian classification)
	Life Class V (Italian classification)

The liquidity/illiquidity of a financial instrument or product requires careful monitoring by intermediaries, as it is in fact characteristic and liable to changes over time.

In this respect, intermediaries establish the frequency (at least yearly) for checking the state of liquidity/illiquidity of financial instruments and products distributed to retail clients. It is clear that whenever circumstances or events substantially altering the liquidity characteristics of a financial instrument or product arise, intermediaries should promptly update the product's classification.

The criteria and requirements to be used for gauging the degree of actual liquidity of these instruments or products are described as follows.

[5] With the exclusion of forward transactions on currency, since these do not fall under financial instruments.

1.1 Degree of liquidity of financial instruments

The Notice's Outcome of the Consultation revealed that the liquid/illiquid 'state' (of a product, *Ed.*) is a factual condition as opposed to a feature inherent to a legal state.

That said, financial instruments should be considered liquid where conditions for their disinvestment within a reasonable timescale exist, at meaningful prices. In detail, the following conditions (by way of example, but by no means exclusive) may ensure a high degree of liquidity:

- the financial instrument is traded on a regulated market or on a Multilateral Trading Facility (MTF) as described in paragraph 1.1.1;
- the financial instrument is traded by a systematic internaliser having the characteristics detailed in paragraph 1.1.2;
- the intermediary distributing a financial instrument or operating as a direct counterparty ensures the condition of liquidity by adopting formalized internal rules on trading, as per characteristics detailed in paragraph 1.1.3; and
- an intermediary distributing a financial instrument or operating as a direct counterparty guarantees that issue's buy-back as per the matters indicated in paragraph 1.1.4.

1.1.1 Regulated markets and MTFs ("over-the-counter")

The structure and functioning of regulated markets and Multi-lateral Trading Facilities (MTFs), which usually express a plurality of interests, may permit the aforesaid conditions of liquidity to be met. Therefore, a financial instrument can be assumed as being liquid if it is traded in such venues, which must be characterised by <u>at least one of the following conditions</u>:

- the presence of at least one market-maker/specialist, responsible for ensuring – on an on-going basis – trading bids on sale and/or purchase sides[6], under spread and quantity restrictions;
- the presence of a number of counterparties (not necessarily market-makers/specialists) making sale and purchase trading bids on a specific financial instrument (e.g. order-driven auction markets, order-driven ongoing trading markets without a specialist[7], etc.).

[6] The on-going obligations to formulate sale trading bids may be dependent on the availability of the financial instrument.
[7] This category includes the order driven execution venues which envisage the combination of the bids as per the on-going trading methods and the presence of liquidity providers, who may get involved on the sale side only (see previous note).

However, due to changeable financial conditions and specific market contexts, the trading venue may not always express the component of comparison and plurality of interests, heralding conditions of liquidity.

In detail, any presumption of a trading venue's liquidity would be invalidated if one of the following were to apply:

a) impossibility to resell the financial instrument on the same trading venue within a reasonable period of time – an investor has to have the opportunity to sell his/her financial instrument within a reasonable period of time, so that changes in market conditions do not significantly impair its value, with respect to the moment the request to disinvest was made. Therefore, trading bids executed beyond the maximum deadline of three business days after the order is received, at prices consistent with the market and in quantities in line with retail clients, are considered as not complying with the criteria of efficient saleability of the investment;

b) lack of pre-trade and post-trade transparency of the trading/order-execution venue, bearing in mind the criteria, laid down by the (Italian) Markets Regulation, Article 32, for financial instruments other than shares admitted to trading on regulated markets; or

c) the existence of hindrances (the market's own rules, economic penalties, etc.), which might pose limits to market entrance or to the presence of other parties interested in contributing trading bids on their own account and/or on behalf of third parties.

Having ascertained that the condition (a) has been met, so as to assess the conditions of liquidity, intermediaries may refer to further indicators (used by way of example, but not limited to), which will have to be compared with the standards of the benchmark market. These include:

- the absence of daily transactions for a period of '*N*' days;
- turnover velocity, namely monthly traded volumes versus amount issued, under a certain predefined threshold; and
- the absence of trading bids by specialists/market-makers over a period of '*N*' days.

Benchmark markets are those identifiable by the intermediary on which the same financial instruments and/or similar instruments are traded, which satisfy the requisites described above, and in respect of which the conditions set in points a), b) and c) above do not apply.

Financial instruments to be issued, or issued but not yet traded on a regulated market or an MTF, may be considered liquid provided that the issuer/intermediary undertakes to have them traded in one of the aforesaid execution venues. The latter guaranteeing the conditions of quality indicated above, within a period of time not exceeding 90 business days as from:

- the settlement date of the financial instrument on the primary market;
- the date the commitment mentioned above is undertaken,

unless events or circumstances occur – not depending on the issuer's/intermediary's will or diligence – making it impossible to observe such a timescale, and provided that any delay is limited. The intermediary will have to inform the client in writing, in a clear and understandable manner, that the instrument will be traded on a specific execution venue within 90 business days.

1.1.2 Systematic internaliser

When the execution venue is represented by a systematic internaliser, this will have to undertake the commitment to guarantee – on an on-going basis – trading bids on the purchase and/or sale side[8], whose prices will be regularly updated in accordance with the spread and volume limits suitable for ensuring:

- a prompt disinvestment, usually within three business days of the client's order;
- meaningful price conditions[9].

Investors must be able to access the internaliser's prices on the basis of clear, non-discriminatory rules.

The systematic internaliser must satisfy the following requirements:

- <u>bid/ask spread extent</u>: the spread between the purchase proposals (bid price) and sale proposals (ask price) cannot be greater than that identified in the procedures of the systematic internaliser, on a consistent basis with the principles described further on in section four of this document ('Pricing rules') and in any event with information publicly available on the regulated markets or the MTFs envisaged in paragraph 1.1.1 for similar liquid securities;
- <u>minimum volume per bid</u>: this volume must be formalized in the intermediary's procedures and it will be defined according to both the characteristics of the relevant financial instrument and the type of clients of the systematic internaliser, so as to ensure a client may disinvest a security within a reasonable period of time (usually three business days after the relevant instruction);

[8] See note 5.
[9] See note 1.

- ratio of investors' sale orders to orders executed within one day of them being received: the ratio shall not be lower than a given, pre-defined percentage threshold, formalized within the intermediary's internal procedures; and

- pre-trade and post-trade transparency, taking into account the criteria set for financial instruments other than shares admitted to trading on regulated markets, as per (Italian) Markets Regulation (Article No.33).

The systematic internaliser will have to ensure both observance of the principles detailed in section four of this document ('Organisational Rules on Pricing') and the traceability of the operations so as to support the liquidity of financial instruments. Each trading day, the systematic internaliser will file and store the data useful for verifying the 'maximum spread' and 'minimum volume' commitments.

1.1.3 Internal rules on trading

In the absence of a trading venue – the latter defined as per previous paragraphs – an intermediary may also guarantee the liquidity by establishing, adopting and implementing formal internal rules (that might not make the intermediary a systematic internaliser) which define trading procedures and formalities for the financial instruments in this scope, capable of ensuring the client:

- a prompt disinvestment, usually within three business days of the client's order;

- meaningful price conditions[10],

according to the spread and volume principles and criteria, outlined above for the systematic internaliser.

An intermediary may also meet the requirements described above thanks to third parties with whom it has entered into specific formal agreements, guaranteeing trading of the financial instruments.

Among other things, the internal rules on trading must allow for the following on a continuous or periodic basis, via more or less automated procedures and structures:

a) the intermediary to express trading bids, based on precise pricing criteria and in compliance with functioning and transparency requirements/procedures, as described further below, whilst having regard to the organisational rules on pricing as per section four of this document; and

[10] See note 1.

b) facilitate clients' requests execution, on the basis of the proposals referred to in point a) above, within a reasonable period of time.

If internal rules are to meet the prerequisite of liquidity in full, the intermediary will have to establish "meaningful price conditions[11]" by fixing pricing criteria and mechanisms consistent with those that led to the pricing of the very same financial instrument in the primary market, yet in compliance with the spread restrictions for the systematic internaliser, as indicated above.

In this sense, pricing rules must be consistent with the indications reported in section four of this document and, amongst other things, envisage:

- adoption of a pricing model for the bond-instrument component and for the derivative-instrument component (the latter, where applicable), in line with current primary market practice for that specific financial instrument;
- definition of the interest rates curve adopted to discount back the flows generated by the financial instrument, in line with current primary market practice;
- any credit spread applied to the interest rates curve adopted for discounting back and the underlining of any difference with primary market practices, providing clear explanations for this.

In order to ensure both uniform conduct when trading and a permanent condition of liquidity – of a financial instrument – intermediaries will have to establish the relevant trading rules, formally and in detail, within specific internal procedures (regulations). These will include rules on how the prices are formed, on client types and on the instruments admitted to trading, on the relevant types of (market, *Ed.*) access and the (intermediary's, *Ed.*) internal checks on the observance of the procedures adopted.

Furthermore, intermediaries will have to set up appropriate disclosure safeguards aimed at ensuring not only the aspects mentioned above but also the pre-trade and post-trade transparency disclosure[12], involving an equal degree of divulgation.

Intermediaries will have to adopt internal safeguards designed to regularly monitor due compliance with the rules of the operational model set up to support liquidity. More specifically, intermediaries will have to ensure that electronic procedures are set in place to keep records of executed transactions. Thanks to this, it will be possible to run searches on every single (i) financial instrument, (ii) type of transaction and (iii) counterparty admitted to trading.

[11] See note 1.

[12] It is considered desirable to provide – during trading hours – the best purchase or sale price conditions and related volumes; price, volume, date and time of the last contract concluded. By the start of the following trading day – in relation to each financial instrument – the number of contracts concluded, the total volumes traded and the related equivalent value, as well as the minimum and maximum price.

In the offering documentation and in the forms handed to clients when subscribing/purchasing a financial instrument, intermediaries will inform clients of the condition of liquidity guaranteed by the internal rules on trading, mentioned above, whereas they will illustrate the relevant trading formalities in the strategy for order execution and transmission.

With regards to financial instruments already on the secondary market and in relation to which the condition of liquidity was not envisaged at issuance, an intermediary, who intends to ensure this condition via the afore-mentioned internal rules on trading, will have to ensure appropriate disclosure, either by publishing notices on its website or by displaying notices at its branches (where possible).

1.1.4 Buy-back commitments

In the absence of a trading venue and internal rules on trading, as described in paragraphs 1.1.1, 1.1.2 and 1.1.3 above, the condition of liquidity of a financial instrument may also be guaranteed by an intermediary establishing formal internal rules and procedures based on a commitment to buy back (hereafter "Commitment") the financial instrument, according to pre-defined criteria and mechanisms in line with those which led to the instrument's pricing on the primary market.

The Commitment:

- *per se*, is not an activity of systematic internalisation by an intermediary, unless all the requirements envisaged by EC Regulation No. 1287/2006 are met;
- *per se*, is not necessarily a derivative financial instrument.

Newly issued financial instruments

The Commitment, based on pre-defined pricing terms, may be undertaken by the parties indicated below, possibly by availing themselves of a third party intermediary with whom they have signed formal agreements, aimed at guaranteeing the Commitment:

- the issuer of the financial instrument;
- one or more parties in charge for placing the financial instrument.

In cases where the Commitment is directly taken on by the issuer at issuance (of a financial instrument, *Ed.*), this becomes a right enforceable by the majority of the subscribers of that financial product. The contract document for formalizing this Commitment is represented by the offering documentation. More specifically, by the general provisions in the summary notes, the disclosure notes or the final conditions, since:

a) the specific issuance which the Commitment is undertaken for, must be unequivocally identified;

b) indications must be provided on (i) the actual ways investors will be able to enforce the Commitment, (ii) pre-defined pricing terms and conditions and (iii) the intermediaries in charge of the placement (of the financial instrument, *Ed.*).

That said, it is regarded as essential that the Commitment be made formal also in the documentation handed over to and signed by the clients, in order to finalise the undertaking of the same.

A similar case is where the Commitment is undertaken, at issuance, by one or more parties in charge for the financial instrument placement, possibly by availing themselves of a third party intermediary with whom they have signed formal agreements for guaranteeing the Commitment.

In such cases:

a) the Commitment is valid solely for those investors who subscribe a financial instrument through the services provided by the specific intermediary which has decided to undertake the Commitment;

b) the contractual documentation to finalise the Commitment is represented by the forms and documents, issued in the name of that intermediary along with a printed header, that are to be provided to the clients who sign them;

c) the client's right to sell, based on the Commitment, must not be restricted or jeopardised by transferring the securities deposit to another intermediary. In this latter case, it goes without saying that the right of sale, at the price terms pre-defined in the Commitment, can only be exercised vis-à-vis the intermediary that undertook the Commitment, through a request sent by the new intermediary.

Financial instruments already present on the secondary market

With regards to financial instruments already present on the secondary market for which, at the time of issuance, no Commitment has been contemplated in the disclosure documents, an intermediary who – originally – issued the financial instruments[13] may choose to take on the Commitment, if necessary by availing itself of third parties with whom it has entered into specific formal agreements. In this case, the Commitment will have to be backed by adequate disclosure ensuring investors are effectively informed and aware of it. Accordingly, arrangements may be made to publish notices on the website of the issuer intermediary and communications to individual placers.

[13] The issuer will be interested in taking on the Commitment subsequent to the issue only to the extent that it operates in the capacity as intermediary.

In cases where the Commitment is taken on by an intermediary[14], the Commitment will have to:

a) be backed up by adequate disclosure, to be provided in such a way as to ensure that every client – of said intermediary – holding the financial instrument in question is aware of where and how the information is available. In this respect and without prejudice to providing adequate disclosure on the first possible contact with the clients concerned, the intermediary should provide the client with specific disclosure within the periodical reports. Further alternative arrangements may be taken: such as publishing notices on the intermediary's website and displaying notices at branches (where possible);
b) be made official vis-à-vis those clients planning to purchase such instruments, in the documents and forms provided to the clients who sign them.

Features of the Commitment

The formal buy-back proposal must include pre-defined pricing criteria and mechanisms, consistent with those which led to the financial instrument pricing on the primary market.

In order to ensure liquidity of a financial instrument, rules for establishing the pricing must be consistent with the indications provided in section four of this document, and at least envisage:

- adopting a pricing model for the bond-instrument component and for the derivative-instrument component (the latter, where applicable), in line with primary market practices for that financial instrument;
- defining the interest rate curve, adopted to discount back the flows generated by the financial instrument, in line with current primary market practice;
- the potential credit spread applied to the curve adopted for discounting back and the highlighting of any difference vis-à-vis primary market practice, providing clear explanations for this;
- the execution venue and the brief timeframe the order is to be executed within.

Intermediaries will have to specify how prices are determined, clearly and comprehensibly for a client.

[14] Irrespective of the circumstance of having covered the role of placer at the time the security was issued or not.

1.2 Degree of liquidity of insurance products with financial content

Life insurance products with financial content may be characterised as 'liquid' if they meet the following conditions[15]:

- prompt and efficient saleability of the investment;
- application of an intrinsic and dynamic fair valuation mechanism, aimed at ensuring fair conditions for a client when the contract is settled.

Therefore, as capitalisation products are the most common – the so-called revaluation products linked to separate internal management schemes – and usually characterised (as far as the aforesaid conditions are concerned) by a state of 'illiquidity', the comments that follow refer to unit-linked and index-linked products (life class III, Italian classification), or alternatively to capitalisation products, similar to the former products in that these are directly linked to the value of internal units of funds/UCITs or else to indices or other benchmark values.

1.2.1 Readily and efficient saleability of the investment

In order to satisfy the requisite of ready saleability of the investment for index- and unit-linked products, the following conditions have to be met:

- the general terms and conditions of the contract should provide the client with the possibility of disinvesting at any time, in view of the general cross-reference made by the legislator to private initiative when it comes to including clauses restricting redeemability in index-linked products; and
- the insurance company must settle the benefit(s) as soon as possible and, in any case, no later than 20 days from receiving the complete documentation, including therein the days an intermediary needs to deliver the relevant documentation to the insurance company[16].

1.2.2 Fair valuation mechanism

Unit-linked products

Unit-linked products may be linked directly to UCITs, or to internal funds set up by the insurance company, the former investing in financial instruments, UCITs or other assets permitted by Italian ISVAP regulations[17]. In the first case above, the application of a fair valuation mechanism is verified in the event that the products

[15] It is understood that the effective liquidity conditions are affected by the level of the loadings applied at the time of distribution and by the penalization on the exercise of the redemption right (see CONSOB document "Outcome of the consultation", page 30).

[16] In this connection, the companies must provide instructions to the sales network for prompt forwarding of the documentation relating to the subscription, reimbursement and switch transactions between internal funds – see ISVAP Circular No. 474/2002.

[17] See ISVAP Circular No. 474/2002.

are linked to liquid UCITs. In the second case, a fair valuation mechanism is considered implemented when an internal fund invests primarily in liquid securities (which, as such, are subject to significant assessment) and envisages the unit to be valued at least once a week.

Index-linked products

Index-linked products may be linked to:

- stocks, bonds and inflation indexes;
- other benchmarks, e.g. structured assets.

In the first instance – which, as from 1 November 2009 (the date when the new ISVAP Regulation No. 32 dated 11 June 2009 comes into force) will be the only type of new index-linked product allowed – the application of a fair valuation mechanism will be implicit if the following joint conditions arise:

- the indices have requisites such that they can be considered liquid[18];

[18] On the basis of the matters envisaged by ISVAP Regulation No. 32 dated 11 June 2009, **the share indexes** can be taken into consideration if:

- they are based on shares, traded on liquid and active regulated markets, issued by companies with registered offices in an OECD nation;
- they are commonly recognised by the financial community and repeatable;
- the underlying shares are adequately diversified, in terms of number and related composition;
- they are calculated daily by third parties who are independent with respect to the insurance companies and issuers of the shares on which they are based;
- they are calculated on the basis of objective and pre-defined calculation criteria, made available to those concerned, which also discipline the methods for replacing or eliminating some of the shares on which they are based;
- they are published in national, daily newspapers.

On the basis of the matters envisaged by ISVAP Regulation No. 32 dated 11 June 2009, **the bond indexes** can be taken into consideration if:

- they are based on bonds: 1. issued or guaranteed by OECD nations, by local bodies or public authorities of nations in the European economic area or by International organizations which one or more of said member nations are members of, or by parties belonging to OECD nations subject to prudent supervision for stability purposes on an individual basis as per current national legislation or the equivalent regulations of the foreign nations; 2. traded on liquid and active regulated markets; 3. do not contain subordinate clauses which assign the asset a lower rank in the payments with respect to other creditors;
- they are commonly recognised by the financial community and repeatable;
- the underlying bonds are adequately diversified, in terms of number and related composition;
- they are calculated daily by third parties who are independent with respect to the insurance companies and issuers of the bonds on which they are based;
- they are calculated on the basis of objective and pre-defined calculation criteria, made available to those concerned, which also discipline the methods for replacing or eliminating some of the bonds on which they are based;
- they are published in national, daily newspapers.

In conclusion, on the basis of the matters envisaged by ISVAP Regulation No. 32 dated 11 June 2009, **inflation indexes** are admissible provided that they are commonly used by the financial community, calculated periodically by national and supranational public statistics bodies or organizations, their configuration is clearly defined in the policy conditions and that they are used to cover the related technical provisions available which have index-linking, a duration, cash flows, saleability profiles and features in keeping with the corresponding contractual commitments.

- the value of the product fully reflects the underlying index/indices with no tracking error; consequently, any differences between the value of the indices and that of the financial assets in which the company invests are the responsibility of the same.

In the second case – which, as from 1 November 2009 (the date when the new ISVAP Regulation No. 32 dated 11 June 2009 comes into force) will no longer represent a permitted type for the new index-linked products – the application of the fair valuation mechanism will be considered implemented if the following requirements are satisfied:

a) prior to offering the product, the pricing process must be either structured or conducted according to adequate and objective criteria commonly acknowledged by the financial community;

b) in the pricing process, the insurance company adopts a proactive counterparty role in defining the value attributed to the assets underlying the index-linked products. To achieve this, the insurance company commits to adopting adequate calculation models in order to assess the values notified by the counterparty or by the third party and any difference in the theoretical value of the assets compared to the aforesaid values notified by the counterparty or by the third party, whilst also envisaging suitable mechanisms aimed at ensuring that the value of the services is properly determined for the investor's benefit. In this specific context, the rules regulating the issue of the structured asset or the agreements stipulated between the insurance company and the entity issuing the asset or with specialized third parties must envisage that the issuer or third party should take steps - even if there is no quote or if the system regulating the quoting of the assets does not actually give rise to a reliable updating of the values quoted - to determine the current value of the asset, based on pre-defined deadlines in line with the services envisaged in the relevant products and, in any event, at least once a week; and

c) the unit value of the underlying structured assets must be published daily in at least one daily national newspaper and on the insurance company's website.

Section 2 – Rules on appropriateness and suitability of investments

The ranking of the offer and the guarantees of correctness pertaining to the appropriateness and suitability verification cannot fail to take into account the various methods used by the intermediaries, in accordance with the provisions contained in the (Italian, *Ed.*) Intermediaries' Regulations, to develop these procedures as from the start of enforcement of the MiFID.

The proposal indicated below therefore takes into account these aspects and remains sufficiently general, so as to permit each intermediary to implement solutions compliant with the legislation whilst respecting each intermediary's achievements in course.

Appropriateness assessment

Appropriateness pertains to the verification of the client's ability to comprehend the nature and the features of the product and the associated effects also in terms of risk.

When assessing the appropriateness in relation to products with scant liquidity, the intermediary will have to adopt instruments/methods/procedures which are capable of discriminating between the financial products on the basis of the different levels of complexity of these, bearing in mind that scant liquidity and the presence of structural costs are factors which contribute to the complexity of the product.

Thus, the intermediary will have to identify the specific macro-categories of financial products in relation to which information on the client's knowledge and experience must be acquired, or generally:

- insurance products with financial content;
- structured bonds;
- certificates;
- OTC derivatives.

Observing the diversity of the questionnaires and the operations of the individual intermediaries, information on the client's financial knowledge/experience can be acquired using various methods, provided they are compliant with current legislation.

For example: the information can be acquired by financial product macro-category, such as those identified above, possibly proposing, in connection to this, to specify an appropriate and sufficiently detailed description which allows the client to correctly and clearly comprehend the complex nature of the product, as well as the potential effects which could arise from the possible existence of derivative components.

The intermediary can acquire the information supplement, which becomes necessary so as to correctly carry out the appropriateness/suitability test in relation to financial instruments with scant liquidity, also when updating the client information set.

The flexibility of this approach makes it possible to maintain the validity of the information already acquired by means of various profiling questionnaires, envisaging the integration only at the very moment when its acquisition becomes necessary on account of the client's desire to invest in an illiquid product and/or the intermediary's initiative in proposing it when the latter has been able to check that the client has a degree of knowledge and experience which is more specific than that originally indicated in the questionnaire.

Example: within the sphere of the profiling questionnaire, the client may have indicated a general/generic level of knowledge/experience in relation to bonds, which it would be necessary to provide further details on and more deeply analyze if the client were to effectively invest in a structured bond.

Suitability assessment

The suitability assessment is typically carried out taking into account the degree of risk (established by the intermediaries on the basis of the respective methods) of a financial product in the transaction: in this respect, it is necessary that a separate and independent assessment of the various risk components be carried out in the process for classifying the products by degree of risk, on the basis of two principles:

- the "multi-variability": in the process assigning the degree of risk to a financial product, the most significant types of risk (issuer/counterpart risk, market risk, liquidity risk) must necessarily be evaluated, taking into account the nature of the product;
- the "non-mitigating/mediating nature" between elements of greater and lesser risk: e.g. a high level of issuer/counterpart risk cannot be mitigated by /mediated by a contained level of market risk.

This separate and independent assessment of the three macro risk factors (issuer/counterpart risk, market risk, liquidity risk) must remain traceable and monitorable by the intermediaries, so as to be able to be used both for the purposes of an internal check and for the purpose of checks by the Supervisory Authority.

The suitability test will therefore be carried out on the basis of these principles.

The parameter represented by the period of time the client wishes to maintain the investment (so-called holding period) must adopt independent importance for the purpose of the suitability tests. It will be directly and specifically placed in relation with the duration and liquidity of the transaction(s) recommended to the client, rather than incorporated in an inevitably approximate manner in the synthetic profile of the same.

Transactions involving financial products with a high degree of illiquidity for those customers who have declared an investment timescale shorter than the standard duration of the product should as a rule be considered to be unsuitable, and as such not recommended. Transactions should also be considered to be inadequate which concern liquid or partially liquid products characterized by structural costs (to be incurred by the client at subscription or as early divestment charges/penalties), in relation to which the client declared an investment timescale shorter than the period of time estimated by the intermediaries to amortize these costs – on the basis of their models developed for this purpose.

Intermediaries who adopt a portfolio suitability logic when defining the reference timescale of the portfolio will have to consider, for the purpose of updating the procedures, the relative incidence of the instruments and the illiquid financial products (and products with structural costs) and the deviation of their duration, or the period estimated as necessary for amortising the structural costs, with respect to the client's reference timeframe. The intermediary is however able to gain information on the various holding periods of the client by quota of assets and, on the basis of these, ensure their relative compatibility.

Section 3 – Rules for monitoring OTC derivatives

3.1 General aspects

First and foremost, it is believed that the application of the Notice can be achieved correctly, taking into account CONSOB's specifications contained in the correlated document "Outcome of the consultation" and, in particular, the following statement: "*The indication […] regarding the monitoring of the continuing ability to hedge OTC derivative transactions entered into with clients does not have a sphere of general application. As explicitly highlighted in the same Consultation Document, it is applicable solely in the presence of a stringent supposition in fact created by the circumstance that the intermediary, when implementing the transaction, explicitly presents itself to the client as a supplier of hedging instruments for risk positions held by the latter*"[19].

On this basis, the correct implementation of the indications appears necessarily and closely linked to the tangible features of the transactions set up by the individual intermediary with its clients.

The above leads to the specific obligation of bearing in mind that the "hedging purpose" of OTC derivative transactions does not *per se* appear as attributable to one unequivocal meaning, since – in the unrestricted performance of the business autonomy – this concept may translate (and effectively translates) in cases with differing scales/ranking (of the hedging purpose, *Ed.*).

In fact, alongside hedging transactions concerning a (specific, *Ed.*) asset or a liability item which can be identified separately, fully or partly hedged (which we can summarily call "**specific hedging**"), other types of hedges emerge which do not have a specific financial statement item under their scope. These include without doubt the case where the element hedged is a group of assets or liabilities or a portion of them – for example the client can choose to hedge the interest rate risk with reference to a percentage of its overall indebtedness or the exchange rate risk on the net financial position in foreign currency ("**aggregate hedging**").

Another case of hedging comes about when the hedged element is a future transaction deemed to be highly probable – for example, the client frequently carries out transactions hedging the exchange rate risk applied on estimates of its own overall exposure in a specific future period rather than in relation to specific commercial transactions ("**hedging of future transactions**").

[19] See pages 79-80. The underlining applied here is not present in the original version.

3.2 Practical recommendations for monitoring

The actual acceptance of the hedging purpose considered by the client and intermediary, therefore, cannot fail to reflect – thereby diversifying them – on the contents and on the methods of the monitoring activities which can be performed periodically in accordance with the request of the Supervisory Authority on the development of "hedged positions".

This stated, one can indicatively, and for the purposes concerned, set the monitoring activities after conclusion of the OTC derivative transactions, distinguishing between the afore-indicated macro-category of "specific hedging" and the other two macro-categories of "aggregate hedging" and "hedging of future transactions".

Obviously, the common requirement is for the intermediary to show clearly to the client the possible hedging cases and acquire from the client information useful for linking the individual transactions to a specific type of hedging (also having taken into account the methods envisaged by the intermediary to gather the information on the investment objectives of the client pursuant to Article 40 of the Intermediaries' Regulations).

With regard to the monitoring "tools", it is necessary to highlight that CONSOB, after having identified the purpose of the "*update of the information provided by the client or in any event available*", in the document "Outcome of the consultation", once again links the "*practical feasibility*" of said monitoring to the fact that the intermediary defines "*under contract with the client, the information it requires to perform the activities in question (for example: information regarding the repayment of loans, divestment of the positions the derivative is intended to hedge[…])*"; the contract with the client, in particular, may represent the venue in which to specify "*the client's liabilities with regard to the updating of the information relating to the trend of the hedged items which the intermediary would not otherwise know about*".

Without prejudice to the fundamental importance of the inclusion – in framework agreements for OTC derivative transactions – of specific clauses in the sense indicated by CONSOB, it appears appropriate to linger on the aspects referred to below, which furthermore fall within the framework of a regular relationship with the client over time.

3.2.1 Specific hedging

On a general basis, the problem of acquiring specific information on the evolution of the hedged items/positions should not exist when the derivative is concluded to hedge exposures relating to loans granted by the same intermediary who trades the OTC derivative with the client. In such cases, the internal procedures should ensure the verification of the transaction executed with respect to the "status" of the loan granted with regular frequency (in any event, no longer than a year).

Specific contractual guarantees, which envisage communication obligations/duties for the client, also in relation to specific requests made by the intermediary, by contrast appear inevitable if the hedged exposure relates to an outstanding loan with a third party intermediary. Irrespective of the direct initiative of the client, the updating of the significant information may take place, involving appropriate recording, also at the time of subsequent contact(s) with the client or periodic visits to the client.

3.2.2 Aggregate hedging/hedging of future transactions

In relation to such cases, it appears necessary for the intermediary to adopt specific contractual guarantees, which envisage communication obligations/duties for the client, also in relation to specific requests made by the intermediary.

With regard to transactions on interest rate OTC derivatives – besides checking any further significant information available[20] – the intermediary may, in any case, profitably compare the notional amount of the OTC derivatives outstanding with the indebtedness of the client as it emerges from the Credit Reference Bureau (i.e.: “Centrale Rischi Italiana”, *Ed.*): in consideration of the long-term duration of this type of contract, the check should be carried out at least once a year.

With regard to transactions on exchange rate OTC derivatives executed with clients which channel regular trading flows from abroad to the intermediary, the latter may, for example, periodically check the performance of the overall collection and payment flows, or in relation to countries/currencies for which the client has set up hedging transactions, (the intermediary may, *Ed.*) implement appropriate checks and requests for information in the event of a significant reduction of the payments and cash flows. If trading flows of this type do not emerge as channelled, it is advisable to go ahead with checks during the year and directly acquire information from the client.

3.3 Follow-up actions

If the monitoring activity reveals misalignments with respect to the hedging purposes originally considered, the intermediary shall take steps, in any event, to inform the client in writing, inviting the latter to contact said intermediary so as to assess the situation.

According to the circumstances come across and in observance of the specific contractual provisions involved, the intermediary may:

- advise the client to change or amend the outstanding derivative (so-called restructuring of the transaction), so as to adapt it to the conditions which emerge as and when;

[20] In particular, considering the evidence which could be indicative of “anomalies” with respective to the on-going hedging function of the derivative.

- propose the early redemption (total or partial) of the derivative or take steps to unilaterally close the position, settling it at the mark-to-market price, in the event the relevant underlying asset no longer exists.

In case, as a result of the assessments made, it is deemed possible to continue with the transaction without taking measures on its relevant parameters, the intermediary will have to apply Article 55 of the Intermediaries' Regulations (as this case would constitute an "unhedged open position") and therefore the intermediary will have to report to the client any losses over the threshold agreed with the client, should this occur.

Section 4 – Organizational rules on pricing

4.1 Introduction

The selection of the valuation methods and the pricing policies is the responsibility of each intermediary and does not fall within the scope of the Guidelines, which by contrast are centred on the features these methods must have and on the formalities via which they must be adopted by each intermediary for the purpose of ensuring the reliability, objectivity and compliance with the objectives required by legislation.

This part of the document does not apply to insurance products with a financial content, bearing in mind that the pricing is carried out by the insurance company issuing the product: in such cases, the intermediary covers, merely, the role of a placer, under price conditions established *ex-ante* and is not required to observe the reporting obligations pursuant to section 5.5 of this document.

4.2 Policy content

In order to fulfil the duties of fairness and correctness envisaged by regulation, the intermediaries adopt a *Valuation and pricing policy* which identifies, for each illiquid product offered at issuance or traded on (the intermediary's, *Ed.*) own account (or for similar product classes), the valuation methods to be used, the required parameters and the related sources, and the indication of the maximum applicable mark-up.

The Policy is approved by a management/governing body and is subject to periodic monitoring and review at least once a year.

The management body can delegate the approval of the sources of the parameters, envisaged by the methodologies, to the Managing Director/General Manager or to a collective body of an adequate level.

4.3 Methods

The rules for determining the pricing which the intermediaries will use must envisage that:

- the pricing models used are consistent with the degree of complexity of the products offered or traded, are of proven reliability in the estimate of the values and must be fully confirmed by the market operators;
- in the use of valuation techniques, all the significant factors, which the market participants consider when establishing a price, are used as input, for instance:
    - rate curves for discounting and estimating the financial flows;
    - any credit spreads which reflect the issuer riskiness;

- exchange rates for foreign currency flows;
- share prices and share price indexes;
- commodities' prices;
- any volatility and correlations of the market parameters which affect the indexing of the future flows and/or of the financial instrument's notional.

The pricing methods, as well as the related/relevant input parameters, will have to be consistent with those used by the intermediary for the valuation of its own securities' and derivatives' portfolio.

For the purpose of ensuring the reliability, objectivity and compliance of the methods with the objectives required by regulation, the intermediaries:

- ensure that the identification of the methods is carried out involving competent and independent structures, which in turn will take care of validating the methods and testing the related IT applications[21];
- take care to identify and formalize in advance the information necessary for the correct functioning of the models, indicating of the relevant sources[22].

4.4 Mark up

In order to guide the conduct of those involved in investment services when defining the pricing of the products both at the time of offer on the primary market and trading on the secondary market, the intermediaries:

- (must, *Ed.*) identify the component variables of the mark up and define the relevant maximum limits;
- (must, *Ed.*) establish, via specific procedures, the structures (i.e.: internal committees, areas, etc., *Ed.*) responsible for the definition of the mark up to be applied – within the maximum limits identified – to the individual transaction or to an array of similar transactions, and the principles to be aspired to for the effective determination of the mark up.

The internal procedures of the intermediary (must, *Ed.*) ensure that there will be no discriminations between the pricing levels unless they are justified by the characteristics of the transaction.

In order to ensure consistency between the pricing on the primary market and on the secondary one, the intermediaries (must, *Ed.*) use the same methodology for determining/establishing the fair value. The composition and entity of the mark up may, by contrast, result as being different (for example: placement fees will be mark up components typically present at the time of classification of a financial

[21] They can provide useful specifications on the subject, or those laid down in a different prospective, the "New prudent supervisory provisions for banks" issued by the Bank of Italy (see section II, part 4) and the document "Supervisory guidance for assessing banks' financial instrument fair value practices" issued by the Basle Committee.
[22] Compare previous footnote.

instrument on the primary market, and not at the time of trading on the secondary market). The differences in the composition and the entity of the mark up are (required to be, *Ed.)* formalized in the Policy and the related operating powers are disciplined in the internal procedures of the intermediary.

4.5 Monitoring

The effectiveness and the correctness of the methodologies identified for the determination of the fair value and the sources of information used to operate the relevant models are (required to be, *Ed.)* periodically monitored. In this framework, steps are taken to at least compare the results produced by the single methodologies with the prices available on the market for the same product/product family or with the prices of products with similar features.

The intermediaries (have to) adopt controls aimed at checking the consistency of the valuations of the transactions concluded with the clients, during the business day, with the end-of-day revaluations[23].

4.6 Updates and reviews

Before going ahead with the offer of a new product or before including it in the list of the financial instruments/products traded on its own account, the intermediary takes care of identifying the methodologies to use to determine the fair value, possibly classifying the product in one of the categories already existing, and defining the related mark up.

The methodologies identified for each product/product family are subject to annual reviews and every time new methods recognised and well-known on the market are available as well as when the relevant monitoring activities identify critical aspects with regard to the (pricing, *Ed.*) results of the chosen methods.

4.7 Checks

The adoption of the Policy, the effective use of the approved methods and the application of the mark ups within the limits envisaged for the individual products (or product families) are subject to verification by the first, second and third level control structures, each one on the basis of the responsibilities assigned to them by the corporate procedures of each intermediary.

In order to ensure the reconstruction of the activities carried out, taking into account that envisaged in the previous section about Monitoring, the intermediaries will have to file the set of parameters used by the pricing

[23] In the "end-of-day revaluations" the intermediary may use end-of-day data or that pertaining to another moment identified, on a long-term basis, by the internal procedures of the intermediary.

methodologies, deemed representative of the business day[24], for each day the transactions are carried out on.

4.8 Duties and responsibilities

The duty to adopt valuation tools and the related internal procedures takes different forms and pertains to different parties according to the number of intermediaries involved in the offer, placement and trading process and depends on the existence of buy-back commitments.

The determination of the value of the financial instruments is necessary in three different stages of the process:

- the issuance/offer;
- the possible trading after placement (so-called secondary);
- the periodic reporting.

As detailed in the Notice, indeed, the obligation/duty to adopt valuation instruments falls on the "*intermediaries who offer their own issue products or operate as direct counterparts to clients*".

It must also be born in mind that, irrespective of the role of issuer or trader, the Notice makes the intermediary responsible for specifying the fair value and the estimated realizable value, at the time of presentation to the client and at the time of periodic reporting.

For such purposes, the intermediaries can "*adopt, also by means of agreements with third parties*[25]*, systems which allow for the supply of reliable periodic information on the estimated realizable value*[26]" and the fair value of the individual instruments offered.

By contrast, with regard to trading on the secondary market, it is appropriate to make a distinction between the instruments issued, placed or distributed by the intermediary who receives the sales order and the instruments the same intermediary has not carried out any role for in the proposal to the client.

4.8.1 Financial instruments issued, placed or distributed by an intermediary

These are instruments in relation to which the intermediary, so as to fulfil the transparency and suitability test obligations at the time of placement or distribution to the client, has assessed the degree of liquidity (also on the basis of internal trading regulations and of the buy-back commitments undertaken by third parties, adequately formalized) and, where deemed necessary, has adopted measures to ensure this liquidity.

[24] Compare previous footnote.
[25] It should be accepted that the third parties also include those belonging to the same group as the intermediary.
[26] See CONSOB document "Outcome of the consultation" page 53.

The following situations may arise:

- **The financial instrument is traded on a multi-lateral execution venue** considered **suitable** to guarantee conditions of liquidity in compliance with the provisions detailed in section 1.1.1. and therefore reference will be made to the values expressed by the execution venue. This execution venue will be that envisaged by the intermediary's execution strategy for the financial instrument concerned.

- **The intermediary trades as a direct counterparty with the client** (also in the capacity as systematic internaliser, to fulfil a buy-back commitment, or on the basis of internal rules on trading). The adoption of pricing tools compliant with the indications of the Notice is the responsibility of the intermediary who covers the role of trader as well [see above].

- **Presence of a buy-back commitment** by a party other than the placer.
  The pricing methods are already established in the Commitment.
  The adoption of pricing tools, consistent with the provisions envisaged by the Commitment, is the responsibility of the party who has undertaken the Commitment.
  The placer will have to ensure, for the purpose of being able to consider the instrument liquid, that the Commitment is adequately formalized (see section 1.1.4).
  The intermediary's execution strategy will have to identify the counterparty who undertook the Commitment in the role of execution venue for the financial instrument concerned.

- **Presence of a liquidity provider (own-account trader or systematic internaliser)[27] other than the placer.**
  The adoption of "compliant" pricing tools is the responsibility of the liquidity provider.
  If the intermediary intends to consider a financial instrument as liquid on the basis of the disinvestment opportunities offered by the liquidity provider, it will have to make sure - for example by asking for a suitable declaration/statement to be issued - that the pricing methodologies adopted by the liquidity provider are compliant with the indications of the Notice.
  The intermediary's execution strategy will identify the liquidity provider as the execution venue for the financial instrument concerned.

[27] This is the case where the liquidity is ensured to the instrument by a party autonomously or upon the request of the issuer or the placer. In this case, a buy-back commitment does not exist. The intermediary who received the order is however aware that the liquidity provider is the only (or the most probable) execution venue where it is possible to trade the security.

4.8.2 Financial instruments not issued, placed or distributed by an intermediary

The intermediary may receive sale orders regarding instruments that it has not issued, placed or distributed. In such cases, the intermediary, without prejudice to the additional obligations which may derive from providing the advisory service, enters the transaction as an order taker/collector, as an executor on behalf of third parties or as trader on its own account and will have to act in observance of the general transparency and correctness/fairness obligations which, in this case, are represented by observance of the obligation to execute the order under the most favourable conditions for the client, consistently with its execution/transmission strategy.

The intermediary's duty to adopt valuation tools will therefore be applicable, as a specific best execution measure, only in cases where it acts as direct counterpart to the client.

The following situations may arise:

- **The financial instrument is traded on an execution venue** deemed **suitable** to guarantee conditions of liquidity in compliance with the provisions detailed in sections 1.1.1. (in this case, reference will be made to the values expressed by the multi-lateral execution venue itself) and 1.1.2 (in this case, steps will be taken to assess the pricing of the systematic internaliser according to the mechanisms and criteria envisaged in its strategy).
  The execution venue will be that envisaged in the execution strategy of the intermediary for the financial instrument concerned.
  The intermediary may also decide to act as direct counterpart of the client in observance of the best execution principle, offering a price equal to or better than that obtainable in the execution venue.

- **The intermediary trades as a direct counterpart with the client** (also in the capacity as systematic internaliser or to fulfil a buy-back commitment, or on the basis of internal rules on trading).
  In this situation, the intermediary must adopt valuation and pricing instruments compliant with the indications of the Notice.

- **Presence of a buy-back commitment** by a party other than the intermediary concerned, which the intermediary can access, or in any case which is applicable to the securities being sold.
  Since it is very likely that this is the only available execution venue, the intermediary's execution strategy will have to identify the party who undertook the Commitment in the role of execution venue for the financial instrument concerned.
  The pricing methodologies are already identified in the Commitment.
  The adoption of pricing tools consistent with the provisions envisaged in the Commitment is the responsibility of the counterparty who has undertaken the Commitment.

- **Presence of a liquidity provider (own-account trader or systematic internaliser)[28] other than the intermediary.**
  It is very likely that this is the only execution venue available.
  The intermediary will take care to verify the existence of alternative execution venues which guarantee more favourable conditions, in the absence of which it will identify the liquidity provider as the execution venue. Usually, the selection is made in the strategy, but it may be carried out occasionally in the event of receipt of an order on a type of financial instrument not envisaged by the strategy.
  The adoption of "compliant" pricing tools is the responsibility of the liquidity provider, while the intermediary will take steps to assess the pricing of the liquidity provider as per the mechanisms and criteria envisaged in its strategy.

- **The instrument is not traded on a specific execution venue and is not backed by buy-back commitments applicable to the client or which the intermediary may access.**
  This is the situation where the financial instrument is not traded on regulated markets or on a MTF, neither by systematic internalisers, nor by other liquidity providers appointed officially and it is not assisted by buy-back commitments applicable to the transaction.
  Evidently this is a situation where the price of the transaction may be penalizing for the client, precisely due to the illiquidity of the instrument.

  In this case, the intermediary can alternatively:

  - check the existence of a party willing to trade, to whom the order can be sent[29];
  - become the direct counterpart of the client, in observance of the related fulfilments.

[28] This is the case where the liquidity is ensured to the instrument by a counterparty autonomously or upon the request of the issuer or the placer. In this case, a buy-back commitment does not exist. The intermediary who received the order is however aware that the liquidity provider is the only (or the most probable) execution venue where it is possible to trade the security.

[29] This type of case is also considered to include the situation where the intermediary who receives the order closes the transaction with a third party intermediary and, for the purpose of avoiding counterparty risks with the client, acts vis-à-vis the same as transactor on own account. In this case, in fact, the own account intervention only represents an operating method and not a genuine transaction as direct counterparty.

Section 5 – Minimum disclosure set

5.1 Ex-ante transparency: purpose and form of the disclosure set

The intermediaries who distribute products with scant liquidity[30] are required to outline a specific interpretation of the transparency measures vis-à-vis retail clients.

In detail, it is appropriate that the investors be provided with a minimum set of information, regarding each product subject to transaction, via a summary document ("scheda prodotto", product fact sheet) set up by the intermediary, as recommended in the Notice, or in any case via documents likewise drawn up by the intermediary, handed over to the clients in the securities pre-trading phase, which is able to efficiently satisfy the requirement, imposed by CONSOB, of overall and systematic disclosure and at the same time (to satisfy, *Ed.*) the burden of proving that the transparency obligations have been met. The product fact sheet represents a document the intermediary may choose to fulfil the disclosure transparency measures, thereby becoming an optional document.

It is emphasized that, where the intermediary provides the investors with the afore-mentioned disclosure set via the product fact sheet or via specific documents drawn up by the intermediary itself, the latter will be responsible for all the information provided to the investor.

(This said, *Ed.*) The general principle of ensuring consistency between the data included in any product fact sheet and the similar information included in the prospectus for the traded instrument, obviously remains valid.

With regard to financial-insurance products, the intermediaries:

- acquit the *ex ante* disclosure obligations by (means of) handing over the summary fact sheet of the prospectus, drawn up by the issuer companies[31], considering that it (the product fact sheet, *Ed.*) is disciplined in a way as to provide clear evidence: i) of the existence or non-existence of time limitations on the early redemption faculty, as well as of any penalties; ii) of the incidence/weight of different cost components on the invested capital, relative to both the time of subscription and the suggested holding period; iii) of the holding period suggested to the potential investor taking into account the degree of risk and the cost structure; iv) of the investment (plan), including any derivative component(s), and the criteria to determine its value; v) of the probability scenarios for complex-structure unit- and index-linked products;

[30] Irrespective, therefore, of the cases contemplated in sections 1.1.1, 1.1.2, 1.1.3 and 1.1.4 of this document.
[31] It is the only document forming part of the offer prospectus which on a mandatory basis must be handed over to the investors as per Article 32 of the Italian Issuers' Regulation. The summary fact sheets drawn up in compliance with the pre-existing regulations and which fall within the sphere of application of the transitory measures envisaged by the new Issuers' Regulation, retain validity by virtue of the reference made by Article 85 of the Issuers' Regulation to Article 33 of the same.

- are not required to provide periodic reporting[32].

5.2 Content of the ex-ante minimum disclosure set

5.2.1 Primary market

The information to communicate to the client, for the fulfilment of the transparency obligations/duties towards the investor, is that described in the specific form (see Sections 2 and 3). As it is a minimal disclosure set, every intermediary may include any additional information which it considers appropriate to provide to the client.

In detail, specific indications recommended by CONSOB were included in the disclosure set, regarding:

- the unbundling of the various components contributing to the overall financial expense/cost incurred by the client, making a distinction between fair value and costs - also deferred where applicable - which implicitly or explicitly encumber the client;
- any bid-ask price differential;
- the estimated disinvestment value "*of the investment in the instant immediately after the transaction, assuming a situation of unchanged market conditions*"*,* expressed in percentage terms of the nominal amount subscribed;
- the disinvestment methods "*of the positions on each product*"*,* describing the methods and timescales for the possible resale of the instrument;
- comparison with simple, known, liquid and low risk products with a similar duration and, if existing, with widespread, substitute products, with adequate liquidity;
- return scenarios calculated on the basis of a methodology consistent with the principle of neutrality to risk.

[32] See the document "Outcome of the consultation", page 53.

5.2.2 Secondary market

In the secondary market's operations it is regarded that some information, whose representation on the primary market increases the client's awareness of the risk profile of the products, does not present the same degree of disclosure value. Therefore, the disclosure set can be reduced to the significant information typical of the financial instrument's trading on the secondary market.

5.3 Ex-ante disclosure set for debt securities, covered warrants and certificates

5.3.1 Introduction

Here follows an illustration of the minimum disclosure content which is recommended be provided to clients during the offer screening of the investment transactions. The exclusive subject of this part of the Guidelines is the disclosure measures descending from the Notice.

The information included in the minimum disclosure set can be presented to the investor, as above, by means of a summary document ("scheda prodotto", product fact sheet), should the intermediary deem it helpful to provide the client with the information using this means.

When assigning values and filling in the relevant fields, each intermediary will refer to its own pricing policy.

5.3.2 Ex ante disclosure set for debt securities, covered warrants and certificates

Key:

- "N.A.": Not Applicable
- "=": content equivalent to that indicated for structured bonds

FIELD	Structured Bonds	Plain Vanilla bonds	Covered Warrants and Certificates
Unbundling of the issue price structure	Indicate the unbundling as percentages of the issue price into: - bond component; - derivative component; - fees/costs. The sum of the components will necessarily have to add up to 100% of the client's financial outlay. The value of the components will be determined by adopting the calculation methodology set by each intermediary, similar and consistent to that used on the secondary market.	Indicate the fees if envisaged	Indicate the unbundling as percentages of the issue price into: - derivative component; - fees/costs. The sum of the components will necessarily have to add up to 100% of the client's financial outlay. The value of the components will be determined by adopting the calculation methodology set by each intermediary, similar and consistent to that used on the secondary market.
Estimated disinvestment value at the end of placement	Indicate: percentage value, no higher than the financial outlay net of the fees/costs stated in the previous point, subject to any improving conditions which the intermediary wishes to apply to the client's benefit. On the secondary market, the bid price or the bid/ask spread can be indicated, at the intermediary's discretion.	=	=
Secondary Market Listing/Trading	Indicate the trading venue where the sales orders will be sent.	=	=
Disinvestment methods	Indicate a description of the methods and timescales for disinvestment, with explicit indication of the possibility for disinvestment to be more or less solely represented by the proposals made by the same intermediary issuer or by other entities of the same intermediary's group.	=	=
Any bid-ask quotation differential	Where available, indicate the average spreads registered in the envisaged venue for trading on the secondary market; alternatively, a summary description of the methods to determine the spreads which the	=	=

	intermediary will apply can be provided.		
Comparison with similar products	Comparison with simple, known, liquid and low risk products with a similar duration and, if existing, with widespread substitute products with adequate liquidity.	=	N.A.
Return scenarios (1)	Solely for securities with a complex structure, indicate the return scenarios calculated on the basis of a method consistent with the principle of neutrality to risk, and (the scenarios, *Ed.*) determined according to "objective methods", stating in a specific disclaimer that the validity of the simulations carried out must be intended as limited to the precise time when they are carried out.	N.A.	=

(1) Field solely provided for "complex structure" securities. By way of example, yet not exhaustive, a list of payoff types related to "non-complex structure" instruments is presented below (the instruments are considered as such also in presence of a call/put option): <u>Fixed Rate; rising Fixed Rate; decreasing Fixed Rate; Floating Rate (also inflation-linked);Floating Rate with a cap and/or a floor; Zero Coupon; Subordinated, Mixed Rate.</u>

5.4 Ex-ante disclosure set for OTC derivatives

5.4.1 Introduction

The recommendations and indications on transparency reported in the Notice must be interpreted by the operators bearing clearly in mind the specificities of the product concerned. In detail, the offer to clients of a derivative OTC product takes place in a relational context and via trading methods which emerge as specific with respect to other financial products. The intermediaries can effectively fulfil their transparency duties towards the client using various forms of documentation, in compliance with the internal procedures and with the organization of the sales process.

A standard information set that each intermediary may structure and organize freely according to their operating choices is presented below, useful for providing the client with adequate transparency on the derivative OTC product.

5.4.2 General information on the financial product

The intermediary shall provide the client in advance with a series of general information for each type of derivative OTC product offered to the client, with the aim of ensuring the clear comprehension of the product's function/purpose, its functioning, the financial effects consequent to the stipulation of a transaction and the consequent risks the client is subject to. This information will be static in nature, relating to a transaction "type" (namely, usual, generic transaction, *Ed.*) and will be periodically updated.

The illustration to the client of this information included within the minimum ex-ante disclosure set may be accompanied by examples which make it possible to understand and effectively assess the product. All the information might be gathered in a summary document (product fact sheet).

The information, which could be gathered in the product fact sheet, does not pretend to be wholly comprehensive and so the opportunity of supplying the relevant information, in full or in part, in a single document or in a number of documents is preserved:

FIELD	DESCRIPTION
Product name	e.g.: Interest Rate Swaps, Interest Rate Collars, etc.
Description	Summary description of the product, rights/obligations of the parties (e.g.: for an OTC derivative on interest rates: method of determining the interest flow paid by the client and by the intermediary).
Function (or Purpose, Objectives, etc.)	Description of the objectives which the client can achieve via the instrument.
Descriptive terms of a transaction	Description of the elements which make up the structure-type of the product (e.g.: for an OTC derivative on interest rates: definition of the Reference Amount/Notional, Interest Periods, Rate or Bank Amount, Rate or Client Amount, Calculation basis, etc.).
Information provided for assessment purposes	Information useful for appreciating the financial profile of the product. For example: intermediaries may include the historic trend of the market parameters/variables (e.g.: Euribor graph), illustrations of the pay-off by maturity (e.g.: via graphs), examples of results of a generic transaction with respect to specific hypothetical scenarios (applying parallel curve shifts or neutral–to-risk approaches), etc.
Specific risks of the product	Description of the financial risks for the client. Intermediaries will independently decide on how to represent the risks of the product to the client (e.g.: via financial measures, classifications and internal risk factors, description of the conditions leading to negative financial results for the client, etc.).

5.4.3 Specific information on the transaction and on pricing disclosure

Where a retail client intends to finalize a transaction on OTC derivatives relating to a product (after having received the general information set on the product concerned), the intermediary will provide the client with specific information regarding the transaction and the pricing disclosure:

FIELD	DESCRIPTION
Specific terms and economic conditions	Complete indication of the conditions applied to the transaction (e.g.: Reference amount, Interest Periods, Rates, etc.).
Fair Value	Theoretical mid-market value of the transaction as resulting from the intermediary's pricing models.
Hedging costs	Costs incurred for the market risk management of a transaction.
Mark-up	Cost incurred for the intermediary's commercial compensation.
Disinvestment value	In the moment immediately after (the signing and conclusion of a transaction, *Ed.*), it equals the mark-to-market of the transaction (including the commercial mark up) plus the hedging costs.
Disinvestment methods	Explicit indication of any difficulty in liquidation, of the consequent effects in terms of costs, of the liquidation's execution time-frame and of the fact that the only source of liquidity is the intermediary itself.
Reporting	In the phase following to trading, the intermediaries will periodically provide the retail clients with disclosure on the OTC derivative positions outstanding. The disclosure will include summary data of each transaction (e.g.: the reference notional and the final expiry date/maturity) and the mark-to-market/fair value. With regard to the estimated "disinvestment value" of the transaction, the intermediaries may explicitly indicate a precise value in the reporting document or may provide information regarding the methods to determine the "disinvestment value" (such information could be enclosed in the same reporting document or provided differently, for example within the contractual documentation or in the product fact sheet, "scheda prodotto").

5.5 Ex-post transparency – periodic reporting

5.5.1 Introduction

Among the recommendations made in the Notice, point 1.7 sets the obligation for the intermediaries to provide clients holding so-called 'illiquid' products with a periodic report: "*With regard to the periodic reporting on the positions held by clients in products of this type, the intermediaries will have to forward (to CONSOB, Ed.), as per Article 56 of Regulation No. 16190/2007, detailed information on the products held. Specifically, it is necessary that in the disclosure set, sent periodically, the fair value of the product is clearly specified, as well as the estimated realizable value determined on the basis of the conditions which would be applied to the client in the event of disinvestment*".

In the document "Outcome of the consultation" it is also specified that the reporting obligations do not apply to insurance products.

The same document "Outcome of the consultation" (page 53) also makes it possible to identify the counterparty obliged to provide the information on the fair value and on the disinvestment value of the products at the time of the periodic reporting as the "intermediary who permits, through its own operations, its customers to come into possession of illiquid products", emphasising that the initiative was undertaken by the intermediary, who must, by means of the report, "accompany the relationship with the client".

5.5.2 Frequency

The Notice does not state specific time limits for the drawing up of the reporting documents, and in the "Outcome of the consultation" it is stated that "*the intermediary should hopefully but autonomously assess the possibility of providing clients with back information on illiquid products with a frequency closer to that required generally by regulation*".

It is therefore considered appropriate that each intermediary decide and declare in their internal policies the frequency it believes most adequate.

5.5.3 Content

CONSOB lays down that a detailed set of information on the instrument held by the client should be specified in the reporting document, and in particular that the **fair value** and "**estimated realizable value**" of the instrument should be specified. With reference to the latter element, in the "Outcome of the consultation" it is clarified that "*it is appropriate that in the reports the level of the cash listing, gross of any fees which would be paid by the client at the time of actual trading be indicated as the disinvestment value*".

It is also specified that: "*it is only natural that the function of the reporting cannot be that of containing irrevocable purchase proposals for the product by the intermediary at the disinvestment value indicated in the reports, […]. The reports exclusively contain reliable disclosure elements aimed at permitting the client to make assessments on the trend of their investments periodically. The market conditions may lead to price fluctuations which in turn involve changes, even sudden, in the disinvestment values without there being any price guarantee in the reports*".

Therefore, it is important to emphasise that the bid price information will be way of necessity be indicative, since it is strictly dependent on the market conditions.

The minimum disclosure set[33] contained in the document, with the specifications expressed, will therefore comprise:

- Fair value (showing the value relating to the date of preparation of the report, for the purpose of "*permitting the client to make assessments on the trend of its investments*"[34]);
- Realizable value (showing the value relating to the date of preparation of the report, for the purpose of "*permitting the client to make assessments on the trend of its investments*"[35]).

5.5.4 Methods for applying transparency measures within the framework of prior transactions with retail clients.

With regard to the possible methods for applying the transparency methods relating to transactions with retails clients stipulated by the intermediary before the Notice in question, an adaptation structured in subsequent phases is believed possible, so as to permit the intermediaries to organize and mitigate the impacts of these activities.

[33] The eventual inclusion of additional information to left to the discretion of each intermediary.
[34] See the document "Outcome of the consultation" page 53.
[35] See the document "Outcome of the consultation" page 53.

Section 6 – Timescale for procedural updates

The intermediaries are obliged to update their procedures so as to conform, in the shortest space of time reasonably necessary, with the principles and the criteria established by the Notice.

For such purposes, the intermediaries adopt organizational, procedural, IT and contractual solutions, also envisaging a modular approach with incremental steps in said implementation, on a consistent basis with the nature, characteristics and dimensions of their activity.

The solutions put forward, to be implemented within a reasonable period of time, comply with an implementation plan adopted which contemplates the precautions and the expedients to be applied immediately.