

Fractional shares and MiFID II obligations: the investor protection measures introduced by ESMA

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On 28 March 2023 the European Securities and Markets Authority (ESMA) issued a public statement clarifying the MiFID II obligations applying to the marketing and sale of fractional shares.

The statement addresses the specific investor protection concerns surrounding this new investment product, which is increasingly used by neo-banks, neo-brokers and micro-investing platforms to facilitate the investment in listed shares by retail clients.

ESMA identifies the disclosure and investor protection requirements which must be satisfied by investment firms while marketing fractional shares to retail investors through derivative instruments.

The ESMA Statement imposes a ban on the use of the term “fractional shares”. It requires investment firms to apply more stringent product governance requirements and forbids the processing of transactions on these instruments on an “execution only” basis.



Fractional shares are a popular investment tool used by retail investors to purchase a fraction of a share by paying a proportional amount of its purchase price.

What are fractional shares?

Fractional shares are a form of investment in which an investor purchases a fraction of a single stock by paying a proportional amount of its purchase price.

By purchasing a smaller fraction of a share, investors can invest in expensive stocks that they may not be able to afford otherwise. They can also build up a diversified portfolio of shares by investing a small amount of money.



Fractional shares investing has become very popular among neo-banks, neo-brokers and micro-investing platforms, because it provides affordable investment opportunities for retail investors.

The investment is normally structured through OTC (over-the-counter) derivative instruments which provide a fractional exposure to the value of the underlying shares. The investment firm offering fractional shares is typically party to the OTC transaction with the retail client and hedges its risks by purchasing the underlying shares or in other forms.

Other arrangements, such as co-ownership schemes, are also used on the market.

The scope and context of the ESMA Statement

On 28 March 2023 the European Securities and Markets Authority (“**ESMA**”) issued a public statement (“**Statement**”) addressing the specific investor protection concerns raised by derivatives on fractional shares.

The Statement is focused on instruments that enable investors to access fractions of shares by way of derivatives which derive their value from the price of the underlying share. It does not apply to other structures offering a fractional exposure to shares, such as the co-ownership schemes mentioned above.

ESMA highlights that other fractional share structures can also raise investor protection concerns, and some of the clarifications outlined in the Statement may be relevant to those structures as well.

The Statement is addressed to investment firms and national competent authorities and clarifies the application of certain investor protection requirements established under the MiFID II.

General information requirements

ESMA highlights that derivative instruments based on fractional shares are not corporate shares: all information to the clients – including marketing materials – must clarify and prominently describe this circumstance, by stating in plain language that the investor is buying a derivative instrument.

The investment firm must also explain the differences between these derivatives and corporate shares, having regard in particular to dividend and voting rights. It should also clearly outline any specific risks associated with this investment, such as counterparty and liquidity risks.



The ESMA Statement addresses the specific investor protection concerns raised by fractional shares marketed in the form of derivatives.



Derivatives on fractions of shares are not corporate shares and the clients must be informed of this circumstance.



Investment firms must provide information on how and, if relevant, where an order for these derivatives will be executed, and how the execution price will be determined.



The Statement introduces a ban on the use of the term “fractional shares”, which might be misleading.

Ban on the use of the term “fractional shares”

According to ESMA investment firms should avoid using the term “fractional shares” when referring to derivatives on fractions of shares.

The use of this term is potentially misleading and constitutes a breach of the MiFID II requirements.

Information on costs and charges

Investment firms that offer derivatives on fractions of shares must disclose all direct and indirect costs and charges associated with the services and instruments.

This includes disclosing any structuring or embedded costs, as well as mark-ups and mark-downs compared to the market price of the underlying corporate share on a *pro-rata* basis.

It is important that all costs and charges are clearly indicated to ensure that investors have a full understanding of the total fees associated with investing in these derivatives.

Enhanced product governance requirements

ESMA points out that derivatives on fractional shares are complex products under the MiFID II product governance rules. Therefore, investment firms must identify the target market in more detail. This includes a careful consideration of counterparty and liquidity risks.

“Execution only” is not viable

The Statement clarifies that, due to the complex nature of derivatives on fractions of shares, investment firms must always conduct the appropriateness assessment when processing investors' transactions.

Under the MiFID II the appropriateness test is not necessary when the investment relates to non-complex instruments, such as for instance shares listed on a regulated market. These orders can be processed on an “execution only” basis.

The ESMA clarifies that transactions on fractional shares cannot be settled on an “execution only” basis because of the complex nature of the derivatives – even though the transactions on the underlying shares could potentially benefit from that regime.



The target market of investors in fractional shares should be carefully identified and transactions in fractional shares cannot be settled on an “execution only” basis.



The investment firms must always assess whether the retail client has the necessary experience and knowledge to understand the risks involved in relation to the investment in the derivative.

This is of course without prejudice to the duty to conduct the suitability assessment if the investment firm provides investment advice (or portfolio management).

PRIIPs and KID

Where derivatives on fractions of shares are packaged retail and insurance-based investment products, investment firms must provide retail clients with a key information document (KID) prepared in accordance with the PRIIPs Regulation.

What is the likely impact of the ESMA Statement on fractional shares investing?

Investment firms engaging in fractional shares investing through derivatives will have to review their marketing materials to make them consistent with the new guidelines issued by ESMA.

Any reference to the term “fractional shares” for this type of derivatives must be deleted, and the investors must receive clear and comprehensive information on the costs and charges applied by the investment firm.

While the ESMA Statement does not introduce a prohibition to offer derivatives on fractions of shares, it could potentially restrict the marketing of these products due to the enhanced product governance standards imposed on investment firms, and the duty to conduct the appropriateness test with respect to all transactions instructed by the clients.

In case of fractional shares that are not marketed through derivatives, the Statement clarifies that these other structures must be equally clearly, fairly, and comprehensively described and disclosed. However, the Statement does not expressly impose the same ban on the use of the term “fractional shares”, and the same limitations in terms of product governance, appropriateness test, requirements to publish a KID, etc. It remains to be seen whether investment firms will restructure their fractional shares schemes and use different contractual arrangements to limit the impact of the ESMA Statement.



Investment firms engaging in fractional shares investing through derivatives will have to review their marketing materials and internal policies and procedures to comply with the ESMA Statement.

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