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Public Statement

On derivatives on fractions of shares

Background

The active marketing and sale of so-called 'fractional shares' by firms to retail clients is a relatively new phenomenon that has gained momentum in the context of on-line trading platforms and neo-brokers.

'Fractional shares' allow investors to participate in the share performance of an issuer by way of an instrument that tracks the share price but is available at a smaller purchase price, namely the pro rata share price of the underlying share. 'Fractional shares' usually allow the investor to receive the economic benefits stemming from dividends, but normally do not carry voting rights.

'Fractional shares' raise specific investor protection concerns.

While different structures are, from a commercial point of view, described as fractional shares, this statement focuses on instruments enabling investors to access fractions of shares by way of derivatives which derive their value from the price of an underlying corporate share. This statement, therefore, does not pertain to products providing access to fractions of shares in any other way, e.g., co-ownership structures. It should be noted, however, that other structures of fractional shares also raise some investor protection concerns and that some of the clarifications given in this statement may also be relevant for such structures.

This statement, which is addressed to firms[1] and NCAs, clarifies the application of certain investor protection requirements established under MiFID II[2] (and its implementing measures).

Derivatives on fractions of shares

Disclosure Requirements

Firms are required to provide clients in good time before the provision of investment services with a description of the nature and risks of the relevant financial instruments. This includes:

[1] Reference to "firms" include investment firms and credit institutions providing investment services to clients in accordance with MiFID II.
[2] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

General information requirements[3]

All information to clients, including marketing information, shall be fair, clear, and not misleading.

Derivatives on fractions of shares are not corporate shares. No client information on these instruments, including marketing communications, shall therefore suggest to a client that he or she is being offered a fraction of a corporate share. To the contrary, the disclosure shall clearly and prominently describe in plain language that the investor is buying a derivative instrument and explain the differences between these derivatives and corporate shares, also with respect to rights inherent to corporate shares such as dividend and voting rights. The disclosure shall further point out specific risks of these derivatives such as counterparty and liquidity risks. It should also be clear on how, and if relevant, where an order of such derivatives will be executed and how the execution price will be determined.

As derivatives on fractions of shares are not corporate shares, firms should not use the term fractional shares when referring to these instruments. ESMA would deem such use of the term misleading and therefore in breach of MiFID II requirements.

Information on costs and charges including mark-ups and mark-downs

Firms offering these derivatives must clearly disclose all direct and indirect costs and charges relating to them and the services provided. This includes structuring and other costs embedded in these derivatives, as well as mark-ups and mark-downs compared, on a pro-rata basis, to the market price of the underlying corporate share.

Requirements on product governance

As derivatives, these instruments are complex products under the product governance rules. Consequently, the target market for these instruments needs to be identified in more detail considering, inter alia, counterparty and liquidity risks. This is expected to result in a narrow target market.

Requirements on appropriateness

As derivatives are complex financial instruments, an appropriateness assessment needs to be carried out where non-advised services are provided.

PRIIPs

Where derivatives on fractions of shares are packaged retail and insurance-based investment products, the PRIIPs Regulation[4] applies and firms need to provide retail clients with a PRIIPs KID.

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[3] While this public statement only relates to fractional shares created by firms by way of derivative structures, any other structures of fractional shares shall, of course, be equally clearly, fairly, and comprehensively described and disclosed.
[4] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).