FSMA

FINANCIAL SERVICES AND MARKETS AUTHORITY

Communication

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Classification of fractional investments as investment instruments

Scope:

This Communication applies to fractional investments that are offered to the public in Belgium.

Summary/Objectives:

The FSMA wishes, by means of this Communication, to provide explanations of the classification of fractional investments as investment instruments within the meaning of the Prospectus Law of 11 July 2018.

1. Neo-brokers increasingly offer fractional investing

Recently, there has been an increase in the number of investment firms or credit institutions that work exclusively online, via a website or an app. These financial institutions are also known as "neo-brokers". They are often active in several countries in the European Union, including in Belgium, via a European passport under the MiFID Directive[1]. These institutions sometimes offer the possibility of fractional investing.

On the Belgian market, this form of investment is offered for American shares and ETFs, among other things.

Fractional investing enables investors to determine the amount they wish to invest in an underlying share, whatever the price of that share. In exchange, investors acquire a right to part of a share. Shares that are traded at high prices thus become more accessible to retail investors. This form of investment also makes it easier to diversify one's investment portfolio.

However, this type of investment does not have only advantages. Fractional investors need to be aware that in many cases they are not investing in the share itself but in another type of investment instrument that is issued or created by an entity that is separate from the issuer of the share, with legal and economic characteristics that are substantially different from the share itself. The risks and costs associated with fractional investing may differ significantly from the risks and costs associated with the underlying share.

[1] Directive 2014/65/EC of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

2. Fractional investing via derivatives or co-ownership

Given that the structure and characteristics of the fractional shares offered can vary considerably, transparency in this regard is very important. In what follows, we explain in very simple terms the basic features of two structures of fractional investments offered on the Belgian market: fractional investing via derivatives and via co-ownership. This brief overview is, of course, far from exhaustive. The features may also vary from one product to the next. They are, in every case, defined solely by contract.

2.1. Fractional investing via derivatives

The offeror of the fractional investment acquires the underlying shares. The shares are thus part of the offeror's assets. The offeror issues and manages the fractions. The fractions constitute individual contracts between the offeror and the investor, whereby the offeror undertakes to link the value of the fraction proportionally to the value of the underlying share, and to allocate any actions involving the underlying share, such as a distribution of dividends or a share split, in proportion to the fraction held.

Investors thus do not invest in the share itself, but in a debt claim that is issued by the offeror and that reflects a portion of the financial value of the underlying share. The fractions do not carry voting rights. The exercise of voting rights presumes ownership of one complete share, and therefore cannot be exercised if the investor holds only a debt claim against a third party rather than having a direct shareholding relationship to the company in question. The fractions are not transferable to other investors. Custody of the position cannot be entrusted to another financial institution. An investor who wishes to sell his or her position can only sell it back to the offeror of the fraction.

2.2. Fractional investing via co-ownership

In this structure, the offeror of the fractional investment or another financial institution acquires the underlying shares. The shares are placed on a special account with a custodian and are treated as ring-fenced assets. After that, fractions or joint rights to those shares are marketed to investors. They may be marketed by the person who is responsible for creating and managing the fractions, or by another financial institution. In a co-ownership structure, the shares belong to all investors in fractions, including the person who creates and manages the fractions for those parts of the fractions for which no investors have signed up. Who is entitled to which part is recorded in a special set of accounts.

In this structure, investors thus do not themselves invest in a full share, or in a debt claim against the offeror, but in a part (fraction) of a co-ownership of the shares.

In this form, as well, the value of the fraction is proportionally linked to the value of the full share, and any actions that occur in respect of the share are allocated proportionally among the fractions. These fractions likewise do not carry voting rights. They are not transferable to other investors and the position cannot be held with another financial institution. Exiting the position requires that the fraction be sold to the person who created and manages the fraction.

3. Fractional investing gives rise to additional risks and other costs

This form of investment gives rise to risks in addition to those associated with the underlying shares. Without being exhaustive, one can point to:

- counterparty risk: fractional investing via a derivative means that the investor has a debt claim against the counterparty and is thus exposed to the risk that the counterparty may become insolvent. This risk will not arise if fractional investing is organized in the form of co-ownership, and the shares are distinct from the financial institution's assets in such a way that they are not part of the property in the event of bankruptcy. It is not impossible, however, that even in such a case investors may encounter (operational) problems accessing their fractions in the event that a financial institution involved in the structuring runs into financial difficulty.
- liquidity risk: the underlying shares are generally liquid shares that are admitted to trading on a regulated market or equivalent market. This does not apply to the fractional investment. The only liquidity generally offered is a commitment by the person who creates and manages the fractions to buy back the fractions outside the stock exchange.

Fractional investing can give rise to other costs. The bid-offer spread for the fraction may thus differ from the bid-offer spread of the underlying share. Commissions may vary sharply depending on the offeror or manager. Given the amount involved in fractional investing may be very slight, the commission may be substantial in proportion to the investment.

4. ESMA clarifies the MiFID obligations when offering fractional investments via derivatives

ESMA has, in a public statement dated 28 March 2023, clarified certain MiFID obligations in cases where fractional investing is offered via derivatives. These have to do with obligations relating to transparency, provision of general information, information about costs and fees, product governance and the appropriateness assessment.

ESMA also mentions that certain clarifications in the statement may also be relevant to fractional investing in the form of other structures, such as co-ownership.

Lastly, ESMA recalls the obligation, under the PRIIPs Regulation[2], to make available a key information document in the event that derivatives on fractions of shares are being offered. The FSMA takes the view that this obligation may also apply to other structures.

[2] 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).

5. Prospectus or information note in Belgium if fractional investing gives rise to the creation of a separate investment instrument

When implementing the Prospectus Regulation[3], the Belgian legislators opted to expand the scope of the said Regulation. In the Law of 11 July 2018 on offers to the public of investment instruments and on the admission of investment instruments to trading on a regulated market (hereafter "the Prospectus Law"), the obligation to publish a prospectus or information note applies in principle to every offer of investment instruments to the public.

Investment instruments are a broader concept than securities and also include swaps of cash flows linked to shares (Article 3, § 1, 7° of the said Law) and all other instruments that make it possible to carry out a financial investment, whatever the underlying assets (Article 3, § 1, 11° of the said Law).

If fractional investing is organized via derivatives, then these derivatives are investment instruments within the meaning of Article 3, § 1 of the Prospectus Law.

If the investment takes the form of co-ownership or another structure, then it must be determined on a case-by-case basis whether a separate financial product is created, with legal and economic characteristics that differ substantially from those of the underlying share. If that is the case, then the financial product is an investment instrument within the meaning of Article 3, §1, 11° of the Prospectus Law. The following elements may indicate a separate investment instrument with substantially different characteristics:

- an investment in the fraction does not give rise to any relationship, under company law, between the underlying company and the investor in the fraction;
- the fraction itself does not carry any voting rights;
- the fraction is not transferable to other investors;
- the position cannot be held with another financial institution.

Determining whether this is the case always requires an overall analysis of the entire structure and of all characteristics of the offer.

If a separate investment instrument is being offered to the public in Belgium, then this requires the prior publication of a prospectus or, if the total consideration within the European Union is less than EUR 5 million over a period of 12 months, then an information note.

The fact that a prospectus may already exist for the underlying share is of limited relevance only, since this is a different investment instrument with different economic and legal characteristics. For each separate investment instrument, in other words, for each underlying share, a separate prospectus or information note must be published. The prospectuses and information notes may to some extent be standardized, provided the regulations permit this and doing so is not to the detriment of clear understanding on the part of investors.

[3] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Regulation 2003/71/EC.

A prospectus must first be approved by the FSMA, together with any advertisements that are to be used in conjunction with the offer. An information note and accompanying advertisements do not require prior approval by the FSMA, but may be verified afterwards[4].

If this obligation is not complied with, the FSMA may take administrative measures and impose sanctions (Article 30 of the Prospectus Law). Non-compliance may also give rise to criminal sanctions (Article 33 of the Prospectus Law). The court will, moreover, declare the purchase of an investment instrument null and void if it was made on the occasion of a transaction that was subject to the obligation to publish a prospectus or information note, but for which no prior prospectus or information note was published (Article 32 of the Prospectus Law).

[4] See in this regard the FSMA's Communication of 9 July 2019 on the procedures for the submission and handling of dossiers relating to public offers and the FSMA Communication of 20 July 2018 on the procedures for filing the information note.