Policy Spotlight

Fractional Ownership and ETF Savings Plans

BlackRock

Examining direct ETF ownership versus performance derivatives through the lens of retail investor protection


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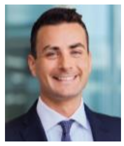
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Executive summary

Protecting investors and promoting market access are the cornerstones of financial market regulation. In recent years, a key driver behind the accelerating participation of retail investors in European capital markets is the growth and adoption of savings plans, enabling fractional ownership of underlying securities such as exchange traded funds (ETFs). We welcome the European Securities and Markets Authority's (ESMA) focus on ensuring fair and efficient outcomes for retail households investing in 'fractions' of UCITS ETFs.[1] We believe there are fundamental differences with respect to investor protection between 'direct investing' in fractions of ETFs versus investing in 'performance-based derivative contracts'. In this regard, we encourage ESMA to analyse and distinguish the nature of these models, and provide necessary guidance on regulating risks involved in investing in derivatives. Doing so will ensure European retail investors have better awareness of the risks underlying the choice of investments offered by different fractional ownership models.

Policy recommendations

1. Provide clarification so investors can distinguish between different fractional ownership models in Europe. Where fractional ownership doesn't involve direct investing in UCITS ETFs, it should not be labelled as fractional shares.
2. Facilitate retail investors' understanding of different types of ETPs, especially from a risk and product complexity viewpoint, by implementing an ETP classification framework for the UCITS ETP markets.[2]
3. Same economic rights must be available with the ownership of fractions of UCITS ETFs as applicable in investing in whole units.
4. Robust custody processes must be in place for direct fractional ownership models, including allocation of units, timely reconciliations, and thorough record keeping procedures.
5. Thorough oversight of the technology used in allocation and reconciliation procedures must be established.

Introduction

Improving retail investor participation in European capital markets has been a key objective of the European Commission's Capital Markets Union Action Plan (CMU). Historically, EU households exhibit greater reliance on cash savings as a means to secure their financial future compared to their peers in other developed economies. However, several recent developments, including stay-at-home measures during the Covid-19 pandemic, technology advancements, and the economic environment, facilitated the emergence of a record number of first-time retail investors in Europe.

For example, in Germany the retail investor base grew to almost 13 million during 2022, as 830,000 individuals started investing for the first time.[3] Similar trends were also observed across other EU member states including France, Belgium, the Netherlands and Italy.[4] In our recent *Policy Spotlight* publication, we have examined the main drivers and key public policy implications of these trends in more details.[5]

A key success behind increased retail investor participation in European capital markets is the growth of digital distribution platforms and flexible vehicles like ETF savings plans. Industry estimates suggest EU retail investors will increase their holdings of ETFs by nearly 3 times by 2026, reaching €350 billion. Over this period, the total number of ETF savings plans are estimated to increase by 5 times, with 20 million individuals investing up to €34 billion in EU capital markets.[6] The revolution of ETF savings plans has just begun. **While over 90% of all ETF savings plans are currently domiciled in Germany, we expect adoption in other EU countries to increase dramatically in coming years.**

EU households' historical reluctance to invest in financial markets has been the subject of significant research by policymakers, academics, and practitioners. Several studies point to savers' lack of investing experience and knowledge of different financial products as leading reasons not to invest.[7] However, the ongoing digital transformation has facilitated increased self-directed retail investors participation in markets. New retail investors say they feel empowered by the simplicity and convenience of digital investing platforms. Many new investors say they opened investment accounts because it was easy to start with a small amount of money, and most say they plan to stick with investing for years.[8] Underlying this emerging trend towards long-term financial well-being is the adoption of ETF savings plans.

Underpinning the success of ETF savings plans is the fractional ownership model helping retail investors' access UCITS ETF markets. While the vast majority of distribution platforms deploy a direct fractional ownership model, there are notable exceptions involving derivatives contracts which may be too complex for retail investors. We welcome ESMA's latest review as it is timely to consider the mechanics of these automated savings plans as investors across Europe are increasingly turning to these products.

What is an ETF savings plan

An ETF savings plan is a monthly regular investment of a fixed amount into a single or selection of ETFs, ordered by self-directed individual investors through an execution-only brokerage's online platform.

Individuals can start investing directly in ETF savings plans with as little as €1, without having to buy whole units of ETFs, while having a wide array of investment choices and full discretion on how long they want to stay invested. Despite this flexibility, ETF savings plan investors intend to stay invested for up to eight years on average.[9]

Benefits of ETF savings plans

ETF savings plans make for an appealing investment vehicle for retail investors for several reasons:

- **Access** – Digital investing breaks down barriers for new investors with more efficient account opening procedures. Access is typically delivered via easy-to-navigate, investor-friendly websites or mobile apps which provide investment opportunities at the click of a button. Furthermore, with UCITS ETFs, investors benefit from low-cost and well-diversified portfolios of local and international investments to suit different investing requirements.
- **Flexibility** – Investors choose their investment horizon and decide when to start, pause, stop or liquidate their investments in a savings plan. The choice of low minimum investment amounts is particularly relevant for younger investors taking their first steps in managing their financial future.
- **Transparency** – Investors get full transparency of the fees applied by the provider of their ETF savings plan. Furthermore, as ETFs are traded on public markets they enable transparent pricing on an ongoing basis.
- **Cost-averaging** – Regular investments reduces market timing risks and averages price fluctuations over time. A notable observation from the past two years is that ETF savings plan investors exhibit strong crisis-resistance and invest for the long-term.
- **Security** – Investing in UCITS ETFs provide additional regulatory protection for end-investors.

Fractional ownership through the lens of end-investor

Traditionally, share and ETF investing required investors to transact in whole units. For retail investors with small capital outlays in the form of monthly cash savings, this could have led to concentration risks in the form of a limited choice of products (too few investment exposures) or inopportune timing (not benefitting from cost-averaging).

A key innovation facilitated by online banks and brokers offering savings plan is allowing investors the ability to buy and sell ETFs for any amount irrespective of the price of the ETF unit. With this development, retail investors can now access the benefits of UCITS ETF markets at their chosen investment budget. Investors can own 'fractions' of ETFs, starting with €1.

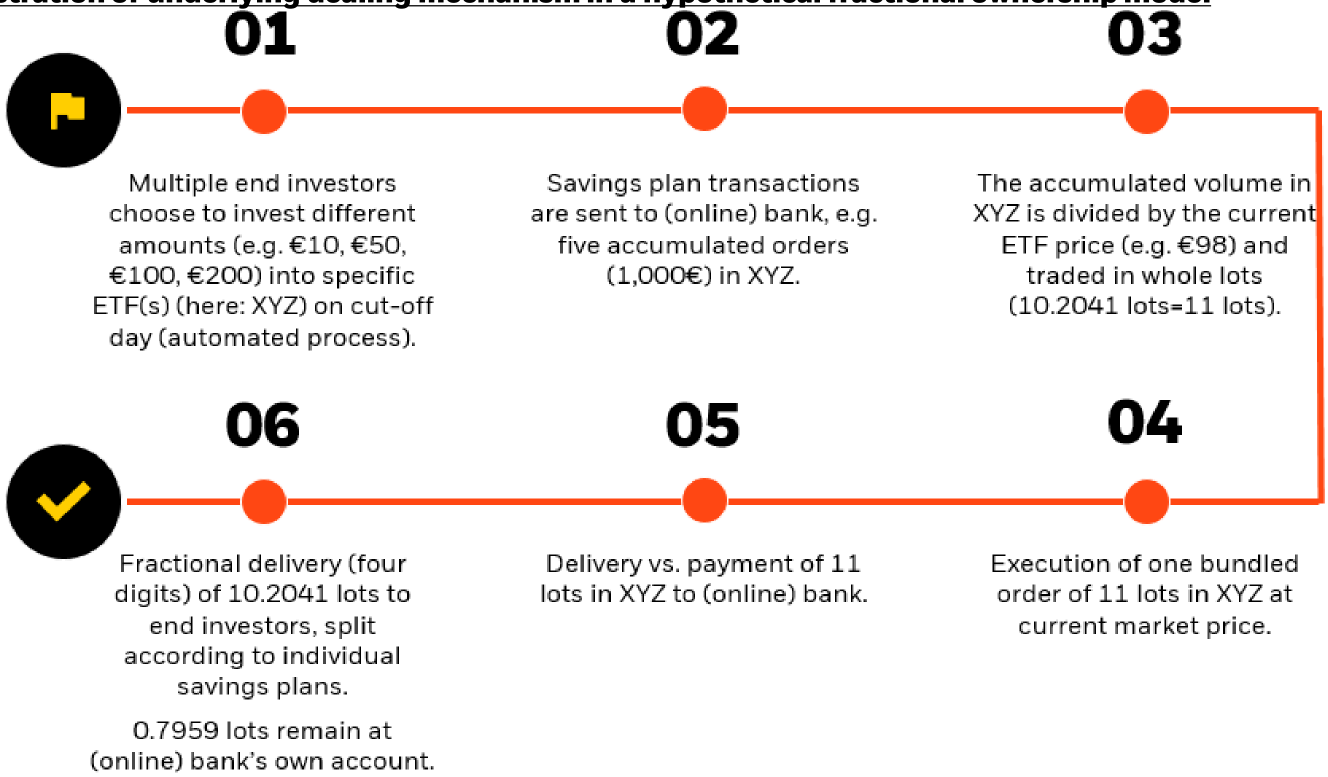
Fractional ownership allows investors to purchase UCITS ETFs – non-complex products suitable for retail investors. This model also comes with custody benefits as the ETF savings plans are backed by ownership of the UCITS ETF by the broker or platform.

Investing directly in fractions of ETFs has become much easier as platforms have married technology with financial markets expertise and capital investment, at scale. The process starts with investors selecting an investment amount and ETF products. The platform then aggregates and transmits these orders to an execution partner who can compile different orders into larger blocks of whole lots, thanks to their pre-programmed nature, before executing them in public markets. Upon receiving the execution, the platform then allocates direct ownership of the fraction of units to end-investors based on their investment amounts. Any remaining fractions are owned by the platform's own account.

With fractional investing, retail investors benefit from broad diversification and access to different investment exposures, while the underlying execution technology is designed to ensure that trading comes with spreads and other costs that are identical to trading whole lots.

The diagram below provides an illustrative overview of the functioning of a hypothetical fractional ownership model.

<u>Illustration of underlying dealing mechanism in a hypothetical fractional ownership model</u>



The need to differentiate direct ownership of ETFs versus derivative contracts to protect end-investors

The majority of ETF savings plans operating in Europe facilitate direct beneficial ownership of underlying UCITS ETFs to individual investors. However, there may be alternative structures whereby investors may not be sufficiently aware of additional risks involved.

Of particular note, are models delivering performance of an underlying financial vehicle (such as UCITS ETF) by means of a derivative contracts like certificates. In certain cases, these models may be marketed as 'fractions' of the referenced ETF. We believe this labelling is inconsistent with the principles of investor benefit and protection under fractional ownership, as discussed in the previous section, and as such should be discouraged.

While fractional investing is designed to ensure relevant ownership benefits are passed onto end-investors, buyers of derivatives-based structures are the creditors of the contract issuer and not the actual owner of the underlying instrument. This distinction is especially important to safeguard investor rights and uphold the future success of retail investing in Europe.

Derivatives are complex investment products, and most retail investors may not have sufficient understanding of such instruments. As such, we believe necessary guardrails should be put in place in savings plans to ensure individual investors are sufficiently aware of what they are investing in and how their rights are protected. Clarification of how fractional ownership works and the difference between investing in fractional shares and alternatives such as performance-based derivatives contracts is urgently required. In this regard, we welcome ESMA's recent emphasis that "derivatives on fraction of shares are not corporate shares," and as such, digital investment platforms "should not use the term fractional shares" when promoting these products.[10]

To balance the twin regulatory objectives of consumer protection and market access, BlackRock advocates fractional ownership structures which provides investors direct beneficial ownership of the underlying ETF. We also discourage labelling of derivatives-based structures as fractional shares.

Finally, we would also like to clarify that investor protection concerns raised with derivatives-based structures are not applicable to the fractional ownership model described in the previous section. As such, future regulatory guidance and action should clearly distinguish between the two structures.

Endnotes

1. See ESMA publishes guidance on fractional shares, March 2023.
2. See Demystifying ETPs: an EFAMA guide for the European investor, 2020.
3. Source: Deutsches Aktieninstitut, 2022.
4. Source: Better Finance, Individual investor behaviour during the COVID-19 crisis in selected jurisdictions, 2021.
5. See BlackRock, Towards More Transparent and Resilient Securities Markets: A Framework to Support Retail Investor Participation, 2022.
6. Source: Research by extraETF, 2022.
7. Based on a survey of 5000 people across five markets in Europe, commissioned by BUX in 2023. Also see European Fund and Asset Management Association (EFAMA), Household Participation in Capital Markets, 2020.
8. See BlackRock, iShares Report on Investor Progress, 2022.
9. Source: Research by extraETF, 2022.
10. See ESMA publishes guidance on fractional shares, March 2023.

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