NEW OPPORTUNITIES IN THE ALTERNATIVE ASSET MARKETPLACE: PEER-TO-PEER LENDING

A LOOK AT THE WAYS THAT PIONEERING CUSTODY FIRMS HAVE BEEN WORKING TO SUPPORT THE GROWING ONLINE PEER-TO-PEER LENDING INDUSTRY.

“As one of the first custodial firms to recognize the potential of P2P lending, Millennium Trust Company has played a key role in servicing the industry and contributing to its remarkable growth.”

–Ron Suber, President, Prosper Marketplace

Peer-to-peer (P2P) lending emerged a few years before the financial crisis gripped the globe. In the United States, Prosper was founded in early 2006 and Lending Club, which began as a Facebook application, opened its doors (figuratively speaking) in mid-2007. The timing was fortuitous as the economic challenges of 2008 and 2009—including the financial crisis, ensuing credit crunch, and subsequent ‘Great Recession’—created a perfect storm of opportunity for the fledgling industry.

The reluctance of banks and other traditional lending institutions to provide consumers and businesses with much-needed capital caused borrowers to look for alternate sources of funding (often at extremely high interest rates). At the same time, the persistently-low interest rate environment and market turbulence sent many investors on a search for potential sources of consistent, higher yields. While traditional lenders seemed unable or unwilling to create a solution, and with many alternate sources of capital difficult or expensive to tap into, both investors and borrowers began to recognize the opportunity that these new P2P lending platforms seemed to offer. In many cases borrowers were able to obtain P2P loans at a much lower interest rate than they would have received from more traditional sources of capital and investors were able to fund loans and earn a higher return on their capital than they were receiving from other investments or savings accounts.

Currently, the industry appears to be at an inflection point. In an interesting ‘twist’ on the classic alternative assets story—investing in alternatives has traditionally been adopted by institutions well before individual investors—the returns earned by relatively small, individual investors from P2P lending have now drawn the attention of advisors, institutions and other large investment industry players. The success of P2P lending has also piqued the interest of traditional lenders who are now exploring ways to participate in this space. This is likely to drive innovation, and new products and services will arise as the marketplace works to satisfy the growing appetite for P2P loans from both individual and institutional investors.
CUSTODY SOLUTIONS FOR P2P LOANS AT EVERY LEVEL

P2P Lending Platforms:
P2P lending platforms look to qualified custodians for a range of solutions. While most often considered for their ability to support the custody needs of a platform’s lenders, some platforms are also finding a need for a qualified custodian to provide key custody support to core business functions. For example, helping them to comply with the Securities and Exchange Commission’s (SEC) amended Custody Rule by acting as the qualified custodian for any special purpose vehicles (SPVs) or private funds that may be part of a platform’s business structure.

Registered Investment Advisors (RIAs) or Fund Managers:
RIAs must comply with the requirements of the amended SEC Custody Rule. A qualified custodian can provide custody for private funds such as hedge funds or separately-managed accounts (SMAs) being created to invest in P2P loans. Additionally, as RIAs and Fund Managers explore the possibility of creating investment vehicles to securitize or leverage investments in these loans, they are looking to these same service providers for custody solutions.

Individual Investors:
Individuals can access P2P loans using both taxable and tax-advantaged accounts. The industry-leading lending platforms have entered into strategic relationships with qualified custodians to facilitate holding P2P loans in self-directed IRAs. IRAs are also able to invest in private funds or engage a RIA to manage their investments in P2P loans via SMAs, creating additional methods of investing for advisors and their clients.

Source: Millennium Trust Company, Schematic Illustration

“Millennium Trust saw the potential of peer-to-peer lending very early on and they have become the go-to custodian in this industry. Most of the leading industry players use the services of Millennium Trust and they have built a solid reputation for providing excellent client service,” said Peter Renton, Co-Founder of Lend Academy Investments.

“We wanted a custodian that understood peer-to-peer lending and the unique custody requirements of a business like ours. Millennium Trust was the natural choice for us.”
CUSTOM CUSTODY SOLUTIONS

A critical element of the nascent P2P lending industry has been the development of business models that include flexible and scalable operations and information systems to meet the demands of; rapid industry growth, increased scrutiny by regulators and unique asset custody requirements. In addition to providing a way for advisors and individual investors to invest in P2P loans via self-directed IRAs, lending platforms have also formed strategic relationships with independent qualified custodians to support other business functions that are critical but may fall outside of their core area of expertise.

There is little difference between the general types of services custodians have historically provided to investors in conventional promissory notes and these new P2P loans. The custodian’s basic role continues to be holding cash and assets on behalf of clients and sending the required account statements. Essentially acting as the ‘middle-man’ between investors and investment advisors.

However, the electronic nature of P2P loans has created an opportunity for a few experienced and innovative custodians to evolve in order to meet the diverse needs of this growing industry. In collaboration with the leading P2P Platforms, a service that once required reams of paper and an occasional obsolete fax machine to document and process has largely gone paperless.

SPECIAL PURPOSE VEHICLES

Special Purpose Vehicles (SPVs) are separate legal entities that are typically structured as a subsidiary or affiliate of a parent company to fulfill a specific (and sometimes temporary) purpose. Some of the most common uses of SPVs in the P2P lending space include:

- **Bankruptcy-remote entity:** Some platforms have created a separate entity that sits between borrowers and lenders to hold the loans. Used as a form of protection for lenders, in the event that a lending platform sponsor files for bankruptcy, its creditors should not be able to claim any of the assets in the SPV (i.e. the loans).

- **Leverage:** As investors look to maximize the potential of P2P loans, some RIAs and Fund Managers are utilizing a leverage provider and creating a SPV to offer leveraged P2P loan funds to investors.

- **Loan Securitization:** SPVs may also be used in the process of securitizing an asset. The securitization process can be structured in a variety of ways depending on the intent. Lending platforms may be structured in a way that essentially securitizes the online loan. While at the same time, an investment sponsor could use an SPV to pool loans of various qualities or to create a structure that could possibly be sold as a type of asset backed security (ABS) to investors.
The SEC Custody Rule

In 2009, the SEC amended the custody rule for investment advisors, also known as Rule 206(4)-2 under the Investment Advisers Act of 1940. On March 4, 2013, they issued a Risk Alert on compliance with the rule. The SEC’s Office of Compliance Inspections and Examinations found significant deficiencies in custody-related issues at about 140 RIAs (more than one-third of the firms examined). The Risk Alert reviewed the definition of custody:

“An adviser has custody if it or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.”

For example, an adviser that serves as the general partner of a pooled investment vehicle (“PIV”) (or holds a comparable position) generally has custody of client assets because the position of general partner gives legal ownership or access to client funds and securities. The custody rule prescribes a number of requirements designed to enhance the safety of client assets by insulating them from any possible unlawful activities or financial reverses of the investment adviser, including insolvency. The custody rule’s key safeguards include:

- Use of “qualified custodians” to hold client assets...
- Notices to clients detailing how their assets are being held...
- Account statements for clients detailing their holdings...
- Annual surprise exams...
- Additional protections when a related qualified custodian is used...
- The audit approach for advisers to pooled investment vehicles...”

The Alert also detailed the advisor deficiencies it had uncovered, including: failure to recognize that they had custody, failure to meet the custody rule’s surprise examination requirements, failure to satisfy qualified custodian requirements and failure to comply with the audit approach for pooled investment vehicles. Deficiencies have resulted in actions that include remediation, enforcement referrals and subsequent litigation.

Role of an Independent Qualified Custodian

- Custody Funds/Assets
- Statements
- Reconciliation
- Reporting
**CONCLUSION**

While there is much talk in the media about the disruption of traditional bank lending models by P2P lending firms, very little ink is currently being spilled about how these changes are also affecting the role of many of the industry’s essential service providers—such as qualified custodians.

The use of a qualified custodian is—in a number of situations—required by the SEC Custody Rule. However, there is no ruling that specifically addresses how these custodians are to develop procedures and systems to provide custody for electronic assets like P2P loans. Instead, these changes are being driven by industry and investor demand, as well as, by custodians that have recognized the potential and dedicated themselves to creating solutions to service the custody needs of an increasingly digital world.

Similar to how technology revolutionized the way individuals and professional traders invest in traditional investments on the various exchanges through online trading platforms, we are now seeing the beginnings of completely new online marketplaces for a variety of alternative assets.

No one knows what the final version of this new marketplace will eventually look like. However, technology is set to play an increasing role in helping to change the way we invest while continuing to comply with regulatory requirements and address concerns about the safekeeping of client assets.

**REFERENCES**

4. Rule 206(4)-2(d)(2)
5. Rule 206(4)-2(d)(2)(iii)
6. National Exam Program Risk Alert

**ABOUT MILLENNIUM TRUST COMPANY**

Millennium Trust Company is an industry leading custodian that helps institutions, Advisors and investors do more by offering niche, expertly managed custody solutions for alternative assets, private funds and retirement plan rollovers. We serve as a complement to services offered by other custodians. Our goal is to make you more successful and productive by professionally managing detailed transactions, providing timely reporting and offering best-in-class service.

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The Economist recently offered this insight:

“A wave of financial-technology (or “FinTech”) firms, many of them just a few years old, is changing the ways in which people borrow and save, pay for things, buy foreign exchange and send money. In doing so they are finding and mining rich seams of profit, challenging the business models of existing institutions and infl ating a bubble of excitement among investors that technology and the internet are about to change banking for good.”