KNOW YOUR KYC

Illuminating the Hedge Fund Perspective

Bloomberg
FOR ENTERPRISE

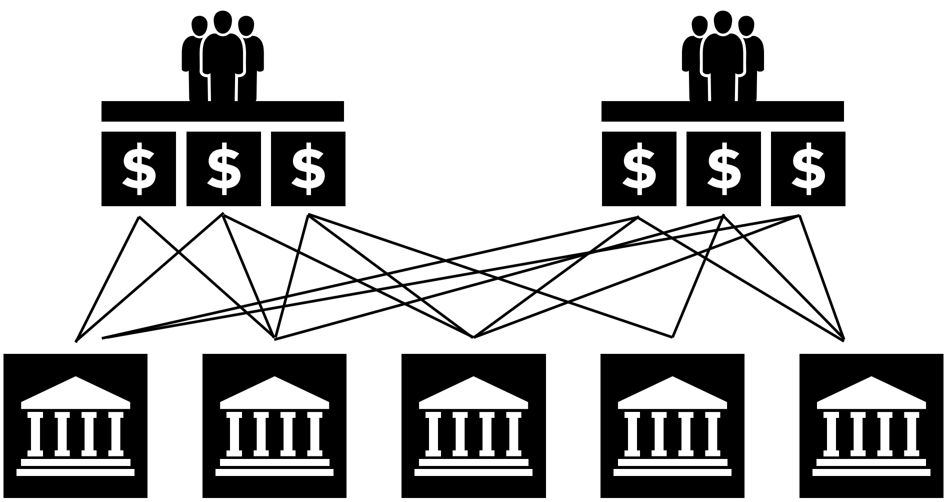
KNOW YOUR KYC
Illuminating the Hedge Fund Perspective

This white paper examines KYC from the perspective of a hedge fund manager and shows how understanding the buy-side's view can help make KYC an easier, more accurate and more sustainable practice for the entire industry.

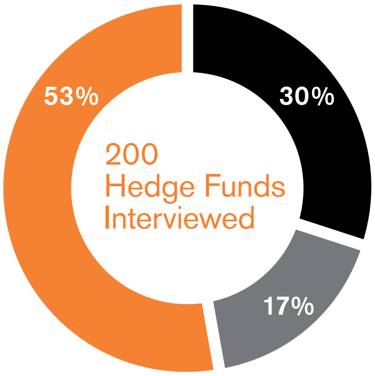
1. AN UNSUSTAINABLE PATH

As a prerequisite for doing business in the financial markets, Know Your Customer (KYC) has become a complex process that is increasingly expensive, resource-intensive and liable to complicate client/broker relationships. For many sell-side institutions that manage one-to-one interactions with multiple clients, KYC represents an unsustainable situation. Given that most of the cost burden of KYC is borne by the sell side, the majority of new solutions on the market tend to focus on sell-side needs. But KYC is fundamentally a two-way exchange of information and agreements, and new solutions need to take the requirements of both sides into account.

For hedge fund firms, KYC poses unique challenges. Hedge funds are increasing the number of their broker relationships due to market opportunities and trading strategies. This, in turn, increases the number of KYC processes that a hedge fund firm has to maintain. The firms are responsible for providing the data and documents brokers request, with limited visibility into how sensitive information will be used and distributed or which KYC policies apply to them. As a result, fund managers may become frustrated when one broker asks for a certain type of information but another broker handling a similar type of business asks deeper questions or requests a different set of documents. This type of confusion ultimately increases the time to onboard and puts strain on the client relationship.



Number of Counterparties



- 10-30 Counterparties
- 30-50 Counterparties
- 50+ Counterparties

2. THE HEDGE FUND PERSPECTIVE

Hedge fund managers operate in a culture that requires privacy and discretion. In order to protect their investors and strategies, they share as little information as possible with any given counterparty. But the data and documents that are required for KYC run counter to this behavior.

Banks often need to request the financial details of investment management firms and identification of fund owners and other associated individuals. It should be noted that if banks could acquire KYC information from other sources, including public databases like EDGAR, they would, since no bank wants to start a new client relationship by making unwanted requests. But because hedge funds are predominantly private companies, banks currently have no choice but to ask hedge funds for the majority of these details directly.

TIME TO TRADE VS. A COMMON POLICY

In addition, hedge funds often begin a trading relationship with a specific trade idea in mind. Many of these ideas are relatively time sensitive, so hedge funds want to execute them as quickly as possible in order to achieve optimal market pricing. But KYC must be completed before any trading can occur, which puts hedge funds in the difficult position of either rushing the process or abandoning the original idea.

This whole dynamic is further complicated because KYC policy varies so much from bank to bank and even within a bank. If a previous counterparty did not ask for the same details or agreements as the current counterparty in order to trade, why does the new counterparty require them? This happens frequently because KYC is governed by different laws, policies and regulatory bodies in various countries and even by product, and sell-side institutions may interpret these regulations differently.

Even more frustrating, the fund may be asked to provide information it knows the bank already has. This often occurs when a fund needs to establish a relationship with a different department or desk within the bank. It not only tests the fund manager's patience but also raises questions about how many copies of the firm's sensitive documents are stored in the bank's servers.

A potential solution would be a common policy for document requirements that collects the superset of information needed from a hedge fund by each desk within the bank. It sounds simple, right? But this goes counter to the desire for a hedge fund to only provide certain data at certain times to certain counterparties. It may speed time to trade but results in fewer hedge funds wanting to deal with a broker.

KYC DATA SECURITY

Hedge funds also have concerns about the security of the information that they are asked to supply. This information pertains to both the hedge fund and its partners—personally identifiable information (PII) and information on trading strategies. Recent news about cybercrimes at banks and losses of customer data adds further worries about data security.

For their own and their investors' protection, hedge funds need to understand who will see the information they deliver, how it will be handled within the bank, where it will be stored and how this storage system is safeguarded. In short, they need to have confidence in the chain of custody of this information. Conventional KYC practices cannot provide this level of assurance.

DOING IT ALL AGAIN

Once the hedge fund has fulfilled the bank's KYC requests, the process is likely to repeat itself, first with any new counterparties and then with new products or changing regulations. Fund managers and others within the firm may be asked to provide renewal information to tens or hundreds of sell-side counterparties. Each request may occur in a different way or use a different file format. When a regulation change impacts a given hedge fund, each of its existing counterparties will request the same additional pieces of information from the fund.

If the hedge fund tries to address these issues proactively, the decentralized and unwieldy nature of KYC hinders these efforts. When critical information at the fund changes, for example a trader leaves the firm and the authorized trader list changes, firms need to notify all of their sell-side counterparties in an efficient and comprehensive way. It is also challenging for a fund to generate a consolidated view of which pieces of KYC information have been shared with which sell-side counterparties at what time and for what purpose.

Common KYC information requests of buy-side counterparties	Common documentation and agreements required
Country of Domicile	Trading Agreements – ISDA Swap Agreements (or variations)
Type of Business	Prime Broker Agreements
Asset Types	Clearing Agreements
Types of Transactions	Formation Documents
Assets Under Management	Proof of Identity
Clearing/Prime Broker Relationships	Tax Forms
Ownership Information	

3. FRAMING AN IDEAL SOLUTION

What many buy-side and sell-side firms are realizing is that KYC is an uphill battle and will continue to be one for the foreseeable future.

Banks have invested heavily in streamlining KYC, but costs refuse to shrink, and incidents of noncompliance have not been eliminated. Brokers continue to spend significant sums of money on KYC but still find themselves on the hook for steep fines. At the same time, the frustration of hedge funds and other buy-side firms continues to grow as the new processes do not fit their workflows.

All of this makes both sides ready to consider a new approach to KYC—ideally one that is both easier and less expensive to manage. And solution providers are stepping up with a variety of new KYC offerings.

Several vendors are exploring the managed service concept, where the vendor establishes and runs a KYC operation independently for the benefit of multiple banks. The idea here is that by centralizing KYC for multiple banks, vendors can improve efficiency because banks share many of the same buy-side clients. As long as participating banks have substantially similar policies, vendors can perform onboarding one time and then use the results to satisfy KYC requirements for multiple banks. Other vendors are pursuing a utility model, in which buy-side data and documents are collected in a single, centralized location that can be shared with the sell-side as needed.

One of the most important aspects of any KYC solution is balancing the specialized needs of the buy-side with the well-understood needs of the sell-side. Because banks are responsible for KYC compliance, many of the solutions vendors are developing tend to be bank-centric. Ultimately, however, efficient and effective KYC depends on a consistent flow of updated and accurate information from the buy-side to the sell-side. Those that best recognize the needs of the content providers will have the most compelling content to provide to sell-side users. Certainly, banks need a KYC solution that is cost-effective and efficient, but buy-side firms need a KYC solution that ensures data security and reduces time to trade. The solution should be flexible enough to accommodate the needs of a wide range of hedge fund types and sizes and be efficient enough to minimize the delays that can damage new relationships before they even begin.

The first generation of KYC solutions may succeed. And if they do, the entire industry will benefit. But right now, before these solutions are entrenched, buy-side and sell-side firms have an important opportunity to think about what the ideal KYC solution might look like. What capabilities would it deliver? What principles would it follow?

4. FIVE PRINCIPLES FOR SUCCESS

BUY-SIDE INFORMATION ACCESS CONTROL

Instead of creating KYC processes designed solely to help banks be more efficient, the industry needs to develop solutions that deliver meaningful value to hedge funds and incentivize them to take an active role in streamlining the process. Hedge funds need control over who can reach their documents and the ability to grant counterparties access to only certain items, limited by their role, geography and instrument type. This access control must be flexible enough to allow modifications as new regulations, roles or instrument types emerge and allow funds to share relevant updates as they occur instead of waiting for individual banks to ask for them. And while negotiations will still be part of the process, collaborative solutions can minimize the back and forth that typically lengthens the time to trade.

CENTRALIZATION

Replacing the current matrix of one-to-one KYC interactions will be critical for attracting buy-side firms and enabling them to participate in the process more directly. Solutions need to establish a single point of collection and distribution for hedge funds and their counterparties. While this is a commonly held view, winners in this space will seize the opportunity centralization provides to add value to users through the savvy implementation of technology. Those that do this well will be best positioned to build a significant community of market participants around their product. In much the same way that the derivatives market is transitioning to clearing through a small number of Central Counterparty Clearinghouses (CCPs) with particular asset class strengths and geographies, the road to KYC centralization may come down to a small set of complementary solutions.

POLICY FLEXIBILITY

To drive sell-side participation, collaborative solutions need to provide sufficient flexibility in the near term. Any solution that only works with a common KYC policy will struggle to find adoption. Policy-agnostic solutions that improve efficiency without neglecting the unique needs of different types of hedge funds will bring more sell-side firms into the fold. Wider adoption will demonstrate the long-term viability of a centralized approach, as well as supply hard data and analytics about buy-side participation that can help move the industry toward a common policy. There is no doubt that a standardized approach to KYC will optimize efficiency, but a more flexible solution that increases adoption has to come first.

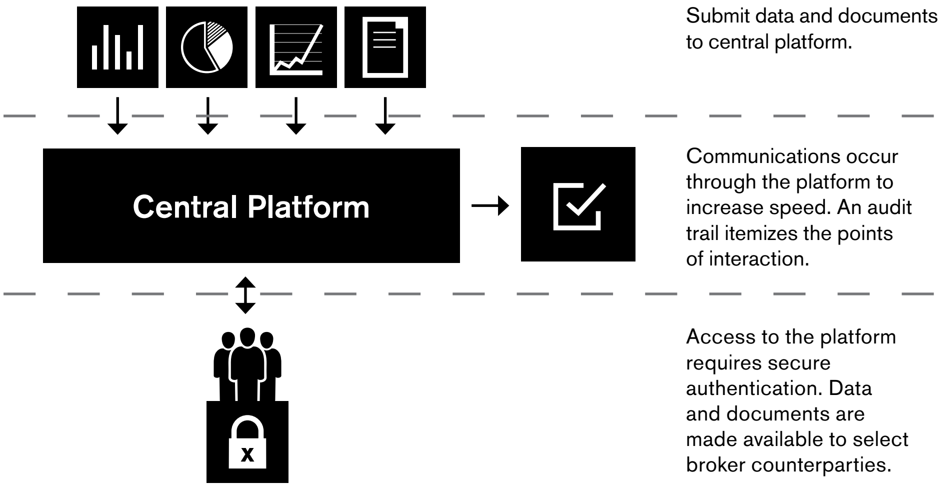
DATA SECURITY

To give hedge fund managers peace of mind and ensure the integrity of their data, KYC solutions need to provide strong, reliable security and rigorous governance. Increasing the transparency of the process will be helpful. Hedge funds and other buy-side firms need more visibility into the chain of custody, such as the ability to run an audit that itemizes which documents have been reviewed by which broker counterparties.

DATA QUALITY

With any solution, vendors will be expected to ensure exceptional data quality, which is a function of domain expertise in data management, normalization and validation. Accurate KYC data minimizes the need to make repeated requests of buy-side clients, which helps make the KYC process much easier.

An optimal KYC workflow for the buy side



Submit data and documents to central platform.

Communications occur through the platform to increase speed. An audit trail itemizes the points of interaction.

Access to the platform requires secure authentication. Data and documents are made available to select broker counterparties.

5. CONCLUSION

KYC is becoming more operationally challenging as its costs and complexities increase. Some KYC legislation is fully implemented, some is complete but not yet implemented and some is still on the way. Regulatory change and consequential internal change to policy are continuous, and every change requires buy-side firms and banks to devote additional effort and resources to the process. In fact, the pace of change is the primary reason why KYC costs have become unsustainable.

What may be equally unsustainable, however, are solutions that fail to improve efficiency and accuracy or ignore the needs of buy-side firms instead of making them willing participants in the process. As new KYC solutions are introduced, hedge funds and other buy-side firms should insist on an easier and more convenient experience.

TAKE THE NEXT STEP

To request more information about KYC and Entity Onboarding Services products, please email hfcompliance@bloomberg.net.

bloomberg.com/enterprise