Lawson Conner Regulatory Update

Blockchain: How Innovative Technology Can Improve Compliance Procedures

Who is affected

Fund Managers, Wealth Managers and Financial Services Firms

Background

The breadth of global regulatory change post the financial crisis of 2008 has been significant and unlike anything the world has ever seen before. The financial services industry has been inundated with new rules and regulations (MiFID, AIFMD, Dodd-Frank, BRRD, Basel II etc…) which have consumed resources and increased spending on compliance at a time when the industry has also been under increasing competition from fintech firms. The fintech industry has boomed by providing its customer base with new innovative products whereby technology has been applied to finance in order to service an increasingly tech-minded clientele. This is not all doom and gloom for the financial services industry however; as the same disruptive technologies can also be used to their advantage. Blockchain is one of these examples and the focus of this paper.

What is Blockchain? Breaking down the myths

One of the hottest topics at present within financial services, "blockchain", appears to be on every industry-event conference and panel debate, and is even slowly creeping in to boardroom discussions. It is no longer a key word saved for young adolescents mining bitcoin from their bedrooms but a legitimate technology that could have the potential to transform the way in which financial services firms operate on a global scale.

Since its inception in 2009, blockchain has moved on from simply being the technology used for cryptocurrencies and is used in other areas such as the movement of information and identity, the movement of commodities and securities, and the digital execution of contracts. The tail end of last year, even saw Nivaura complete the world's first fully automated cryptocurrency-denominated bond issuance that was also cleared, settled and registered on a public blockchain infrastructure. The world of blockchain has moved forward at an incredible speed; but what exactly is it?

Simply put, blockchain is a type of distributed ledger technology (DLT). DLT is a system of digital data that is duplicated, shared, and synchronised across multiple locations. Whilst a type of DLT, blockchain uses unchangeable, encrypted, packages of data stored in a connected chain as the ledger of data. Here, each new piece of data is verified by all locations and then is added to the existing chain of previous data making it virtually impossible to defraud and thus provides the users with a trustworthy source of information.

March 2018

Issue: Q1 2018

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The saving grace of Compliance?

Compliance regulation places a hefty burden on all types of business particularly financial services. However, blockchain can (and will, we predict) play an important role in the Know Your Client (KYC) and anti-money laundering (AML) processes of the future.

Imagine being able to have the ability to inexpensively verify individuals' identity in a time-efficient manner. This is what blockchain allows for. Today, KYC tasks are repetitive in nature which result in data inconsistencies, mistakes, and a duplication of processes. These tasks are also faced with the challenges of using a number of different systems, both internal and external, which inevitably lead to the implementation of manual solutions with the purpose of bridging end-to-end operational procedures. AML compliance also requires extensive documentation requests and verification, as well as proof of identity. All together, these antiquitous processes not only frustrate the client (or client to be) but create an environment prone to high risk factors. These processes can take days, weeks, or even months in some jurisdictions, to fulfil and satisfy the regulators' requirements. As a result, the cost of being compliant is escalating rapidly as financial institutions try to stay ahead of terrorists and fraudsters.

The use of blockchain here would introduce a shared ledger. With this, the processes can be monitored and adjusted in a more efficient way than they currently are. Due to the shared nature of the ledger, a comprehensive database of client activity and background information would be available to all on the network. This would mean that any updates or changes to this information would be communicated and updated in real time; making it much more likely to detect a potential scam or a fraudulent transaction. Giving all departments access to the shared ledger would give them all the client background information and account activity which would result in a seamless stream of knowledge and make the KYC process all the more efficient.

Another key feature of blockchain from a compliance perspective is its practical immutability. As soon as data is inputted and saved into the ledger it can never be changed or deleted. For this reason alone, blockchain has been used as the document of proof for the transferring of digital assets; and by the same token can lend itself to the application of proof-of-process for compliance. The shared ledger can be used to keep track of the many steps required by the regulators. By recording actions and their outputs, an audit trail for regulators to verify compliance would have been created. Due to the immutability of the records there would be no reason to dispute them at any point.

Regulatory reporting

Navigating the ever-changing regulatory landscape post the financial crisis is challenging and costly. Several of the new regulations now require structured, well-defined and complete risk data reporting which is placing extra strain on the financial institutions being regulated. These strains are exacerbated due to the fact that there is still a heavy reliance on manual processes and archaic partially automated processes, particularly in smaller firms. On the other side of the coin, some regulators receiving these mandatory datasets are ill-equipped to manage them impacting their ability to provide effective data analysis, surveillance and a timely effective review process.

Using blockchain for regulatory reporting, could take away several pain points for both the financial institutions and the regulators. Since the data is shared by design, regulators would not have to collect, store, reconcile and aggregate the information for themselves. All transactions are documented immutably on the distributed ledger providing a comprehensive, secure, precise, irreversible, and permanent audit trail. Introducing one shared platform would remove the requirement for each to hold its own replicated records. It could also mean the records would be updated in real time. A blockchain could vastly improve the speed and quality of any regulatory review process since there would no longer be a need for reconciliation.

Financial firms would benefit from a more efficient regulatory reporting process since the distributed ledger would act as both an execution platform and a mechanism to store transactional information. The use of blockchain would significantly improve their ability to resolve compliance issues, react to new regulatory and compliance obligations and address internal audit requirements in a timely and cost-effective manner; as well as improve the quality, accuracy and confidence of and in the process.

Tomorrow's world

Blockchain will not be adopted globally overnight. Setting up and managing an infrastructure to support these kinds of solutions takes time and can prove to be disruptive to begin with. There are no clear best practice guidelines available as to how to streamline the rolling out process. Blockchain technology has overwhelming potential to revolutionise and improve many of the processes within financial services, particularly those that are regulated. However, as a relatively new system, particularly vis-à-vis KYC and financial crime prevention, we are yet to see how the regulators themselves adapt and embrace the possibilities but there is no doubt of the industry-wide benefits that blockchain could bring.

How we can help?

Lawson Conner has worked extensively with our clients to assess the impact of regulatory change. We would be delighted to discuss how we can help support you to meet these new challenges. Our team of compliance professionals can assist you at every stage as you seek to comply with the new regulatory obligations.

About Lawson Conner

Lawson Conner provide regulatory infrastructure and managed compliance services.

Lawson Conner offers customised solutions in the areas of Fund Structuring, Compliance Advisory, Global Regulatory Infrastructure, Fund Distribution, Regulatory Hosting, Appointed Representative Services and ManCo Services.

As a reliable and trusted partner, we create long term value by working with passion, expertise and unparalleled commitment to the industry and our clients.

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