KYC for OTC Desks

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1 OTC Trading Landscape

Over-the-counter (OTC) trading involves trading securities such as equity, derivatives, debt instruments and other alternative assets directly between buyers and sellers - in short, it refers to direct trading in securities between owners and sellers.

In practice, most OTC transactions are carried out between investors and OTC desks that act as a buyer or seller.

More recently, OTC trading has gained popularity as a means to trade cryptocurrencies independently of centralized exchanges.

The crypto OTC market has emerged as an attractive investment conduit for various different actors - from hedge funds to smaller asset managers, family offices, High-net-worth Individuals (HNWIs) and accredited investors - due to several key advantages it holds over exchange-based trading.

These include:

- Higher or non-existent caps on trading volumes
- Greater anonymity and price protection
- Avoidance of sudden price fluctuations during a transaction (known as “slippage”)
- Preventing fluctuations in market prices through increased supply and demand as a result of making an order. Prices can be agreed on prior to the transaction.

The OTC market is growing as more and more institutional and private investors seek to increase the weight of crypto in their portfolios. However, due to the largely private nature of the space, it can be hard to accurately estimate its market capitalization.

In 2018, Bloomberg reported that the OTC market ranged from a daily trading volume of between US$250 million and US$30 billion - a substantial range. As the crypto market has grown significantly in value since then, the current volumes are likely far higher.

As such, OTC desks – which effectively act as a dealer that buys and sells crypto from businesses and individuals that want to avoid exchanges – have proliferated.

However, OTC trading does come with various risks (and opportunities) when compared to centralized exchange trading. This applies to both individuals and businesses carrying out OTC transactions - and the OTC desks themselves.

This guide will outline what those risks are – and how they can be mitigated with effective, automated Know Your Customer (KYC) and Know Your Business (KYB) processes both for buyers and sellers using OTC desks.

2 OTC Trading: Risks

While OTC trading certainly carries several benefits - in particular for buyers and sellers who trade large volumes of crypto – it also presents some very serious risks.

In simple terms, trading through an OTC desk does not provide the same kinds of assurances and failsafes that exchanges provide (though as anyone who has been even superficially following the crypto market will know, exchanges are also not immune to hacks and fraud).

OTC desks themselves are also vulnerable to fraud as they also need to engage in transactions with buyers and sellers.

Key risks of OTC trading include (but are not limited to):

1. Sellers not having – or not actually intending on selling – the crypto that buyers agree to pay for

One of the biggest scams that is carried out through OTC trading is where a seller claims to have the cryptocurrency that a buyer wants to purchase, when in fact they do not actually possess the crypto - or have no intention of actually selling it.

The buyer will be led to believe that they are sending the funds to a party that owns a certain amount of crypto, usually by the alleged seller sending a video or screenshot of the contents of their wallet. Sometimes, when OTC crypto trades take place at a bank or apparently neutral location, a cold storage wallet will be provided to the mediating party, which will not properly check it for the cryptocurrency, before passing it on to the buyer.

Buyers can fall victim to this kind of fraud if they do not effectively check that the wallet the seller claims to own actually contains the crypto they are looking to purchase. In order to verify that a wallet in fact belongs to the seller they are dealing with, buyers should request that the seller send a message to them from the wallet address with a customized message, such as their two names or nicknames.

Sellers that insist on just providing video or image proof of their wallet address should not be trusted, as such visual evidence can be easily obtained online.

2. Refund fraud

This kind of scam can also affect ICO issuers, and is a risk that is usually carried by sellers. A buyer will essentially make the purchase of the cryptocurrency, receive the coins and then request a refund on the transaction from the bank by claiming that they were not aware of the purchase.

In such an instance, certain banks are obliged to make the refund, reversing the transaction. However, as banks are generally not able to trace and then force the cryptocurrency to be returned, the buyer remains in possession of the effectively stolen crypto.

3. Vague contracts

Ambiguous contracts between buyers and sellers can lead to a wide and constantly expanding range of different scams. For large transactions, it's incredibly important to have a trusted legal professional review a contract that is proposed by either counterparty.

Each party's lawyers should be able to verify that the contract has enough level of detail and is legally binding. Typos and vague language in a contract should be a major red flag.

4. Double spending

Another, especially sophisticated scam that can affect OTC trades, double spending involves a buyer or a seller pretending to send the funds or crypto to an address during a real-time exchange, when in fact an associate of theirs is manipulating the blockchain to send the same digital token to another address.

Most of the risks of OTC trading are carried by buyers, though sellers are also victims of fraud.

Crypto exchanges are able to mitigate many of the risks of OTC trading through the use of trustless systems. There is no need for two parties in a transaction to actually trust each other, because the crypto exchange acts as a middleman, buying from the seller and selling to the buyer.

With OTC trading, there is a need for a certain level of trust between buyer and seller. And this is where KYC comes in - it's impossible to trust someone if you don't know who they are.

3 How is KYC currently performed by OTC desks?

Buyers and sellers conducting OTC trades usually perform manual KYC checks on each other. However, the process is far from uniform across the space.

Buyers and sellers also typically carry out KYC checks that include:

- Verifications of buyers' bank account ownership
- Carrying out checks to ensure that a seller truly controls the wallet they claim to be selling the cryptocurrency from
- Confirmation of addresses of counterparties in order to have an avenue to pursue legal action, should the need arise
- Requesting and collecting documents for verification manually via email - which is highly time consuming

However, because the onus is on each party to ascertain and confirm the identity of the counterparty, using manual and non-systematic processes means that **there is plenty of room for risks to enter the fray**.

4 Challenges of implementing KYC for OTC Desks

OTC desks are faced with a tough challenge: maintaining client privacy while also ensuring that counterparties are who they say they are in order to mitigate the possibility of fraud and other financial crimes.

While OTC desks may attempt to carry out their own KYC checks on counterparties manually, there are complexities in doing so effectively. The problem with this approach is that it is:

- Time-intensive
- Resource-intensive
- Easily inconsistent
- Hard to carry out across a comprehensive range of jurisdictions

Effective KYC and KYB processes need to be able to have multi-jurisdictional coverage in order to be able to:

- Adequately assess the authenticity of an individual's provided identity
- Check a corporate counterparty's articles of incorporation and regulatory status
- Understand the solvency status of corporate and individual counterparties
- Evaluate the risk profile of foreign individuals and entities, including their presence on international watchlists and sanctions lists

Depending on the amount of transactions an OTC is engaging with on a daily, weekly, and monthly basis, manually carrying out all of these checks efficiently and accurately may simply be unfeasible - and also impractical.

5 Benefits of implementing KYC for OTC desks

OTC desks can overcome transactional and regulatory risks - as well as the challenges of conducting manual KYC - by implementing an automated KYC solution.

An automated KYC workflow can be seamlessly integrated in an OTC desk's onboarding process. This can effectively carry out comprehensive checks on counterparties that can confirm their identities and risk profiles.

Automated KYC for OTC desks will go through the following steps:

1. ID Document / Certificate of Incorporation

Scanning uploaded identity documents for visual authenticity, image integrity, and document data validation. This can use advanced technologies such as algorithmic and digital tampering detection.

For businesses: checking registration number or legal name against government registries across global jurisdictions. Once authenticated, compliance teams can confirm their registration and status with corporate registries.

For individuals: Optical Character Recognition (OCR) Extraction can automatically extract data from identity documents and images uploaded by users. This information is then cross referenced with verified data stored on government registries and other public databases.

2. Passive Liveness Checks

A relatively new process that is able to verify whether an individual taking part in an onboarding process is in fact the individual being presented in an uploaded selfie image or video - and not an imposter or fabrication.

3. AML Screening

Checking an onboarded individual or entity name against a comprehensive selection of global watchlists that include sanctioned entities, Politically Exposed Persons (PEPs), and references in adverse media.

4. Crypto Wallet Screening

For OTC trading desks, understanding the history of a wallet, as well as other key credentials, is a critical step for mitigating the risk that it is a conduit for money laundering and other financial crimes.

5. Jurisdiction Assessment

Many OTCs need to restrict access to counterparties from certain countries and jurisdictions for different reasons - from complying with global sanctions to tax purposes and avoiding certain regulatory regimes. A robust automated KYC process will be able to filter eligible counterparties according to where they are based, or where their main place of business is.

6. Risk Scoring

Once an individual or corporate customer's identity and credentials have been established, an automated KYC tool will assign a risk score to that investor. This score will then inform a decision on whether to automatically grant that counterparty access to the OTC desk, apply further checks and scrutiny, or to reject them.

7. Enhanced Due Diligence (EDD)

For potential counterparties that have been flagged as a potential risk, EDD processes can be applied that do not necessarily require human intervention from compliance teams. However, many KYC automation tools do also provide customizable options for high-risk subjects to be forwarded to a compliance team, ensuring that restrictions on investment are checked and justified.

6 Case Study: Satoshi Deals

OTC Desks are already optimizing their compliance processes by using KYC-Chain.

One such company is Satoshi Deals, a financial services firm that offers peer-to-peer trading and custodial services to their HNWI and institutional clients.

Last year, Satoshi Deals integrated KYC-Chain's end-to-end workflow solution on their platform. One of the key prerequisites for the Cyprus-based company was to have a KYC solution that complemented their highly intuitive and user-friendly interface - and did not add extra or unnecessary burden on their clients.

Before implementing KYC-Chain, Satoshi Deals faced the following challenges in carrying out their KYC:

1. Running paper-based KYC/AML on their individual clients.

2. An urgent need for crypto wallet checks, as banks are now overwhelmingly requiring them as a required compliance credential.

3. They were looking for a way to digitize their entire onboarding process – both frontend and backend - to have a more complete solution.

KYC-Chain was able to tailor a solution for Satoshi Deals that included bespoke solutions and features that addressed these issues, such as:

- Live API integrations to government databases with real-time data updates every 24 hours.
- Validation of company data for 105 different countries covering over 160m companies and data checks from over 10,000 data source points.
- Algorithmic and anti-tampering validity checks that provide a 40-point likeliness score to spot fake pictures and documents.
- Flexibility to create custom templates and define questions and documents as needed for a specific process.
- Digitally approve or reject each application when all relevant processes are complete.
- Significantly reduced client onboarding times.

7 Final Thoughts

OTC Trading has emerged as a powerful system for crypto buyers and sellers to realize numerous benefits over exchange-based transactions, in particular when it comes to large-volume trades. As such, the space continues to expand, driven by OTC trading desks' offer of higher or non-existent caps on trading volumes, greater anonymity, avoidance of 'slippage' and more.

Nevertheless, the benefits offered by OTC trading are somewhat counterbalanced by the risks involved, which include fraudulent and/or scam transactions that can affect both buyers and sellers.

The root cause of most risks carried by OTC trading are related to the lack of adequate and effective KYC measures being implemented on traders. OTC trading desks can effectively counter OTC trading risks, ensure compliance with global regulations and build trust among their client base by implementing effective and efficient Automated KYC.

By intelligently adopting new technologies that optimize compliance processes and reduce fraud risks, OTC trading desks can fortify their position in the brave new world of decentralization and pave the way for scalable and responsible growth.

About KYC-Chain

KYC-Chain is a compliance dashboard and whitelabel customer on-boarding portal enabling companies to perform due diligence on their customers in accordance with CDD/AML/KYC requirements.

KYC-Chain enables automated on-boarding of people and legal entities by leveraging technology such as robotic process automation, biometric matching neural networks, and blockchain based identity credentials.

Our solutions provide KYC on-boarding that is quick, easy, and for both corporates and individuals, in a blockchain enabled financial world.

Have any questions on how to comply with KYC and AML regulations for your OTC desk?

Get in touch and we'll be happy to arrange a demo.

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