

AMLD5 AND THE ART MARKET

ART MARKET PARTICIPANTS MUST NOW ACT LIKE FINANCIAL INSTITUTIONS TO MITIGATE RISKS

From verifying client identity to reporting suspicious activity, art market participants have seen significant changes to the way they operate as the EU tightens regulations to combat money laundering. In this article, Anthony Verhelpen and Eugénie Dumont look at the impact on the art market and what participants need to prioritize to ensure compliance.

Introducing several changes and new rules, the Fifth EU Directive on anti-money laundering and counter-terrorist financing (AMLD5) was adopted by the EU Commission on 30 May 2018 and should have been transposed into national law by member states in January 2020.

Although it may have been overlooked in some quarters, the obliged entities within the Directive's scope now include art market participants (AMPs). Mandatory AMLD5 compliance is a profound change that will significantly impact customer experience in the art sector, which has a long tradition of commercial and personal confidentiality.

When purchasing or selling a work of art, AMPs will now need to perform due diligence to understand who they are dealing with (customer due diligence) and where the money comes from and goes to (transaction monitoring).

It is not surprising that AMPs have been added to the list of obliged entities, considering how easily money laundering can take place in this historically opaque sector. In a recent case, a UK gallery director has been accused of accepting £6.7 million

in exchange for a 1965 Picasso, *Personnages*. Forged ownership papers were drawn up to legitimize the sale, while keeping the Picasso stored away. The gallery director then 'pretended' to buy it back at a lower price, keeping between 5 and 10 percent of the laundered money in the transaction.¹ Similar transactions have allowed money launderers to use the art market in the past. To mitigate money laundering risks, AMPs must now start acting like financial institutions.

AMPs tried to resist their inclusion as obliged entities under AMLD5, although the impact of this change is yet to become clear. In the early 2010s, a Mexican law (similar to the EU Directives) intended to expose drug cartels and introduced client identification requirements alongside limits on prices for art-related transactions. It resulted in a 70 percent drop in sales within a year, likely because cartels were the biggest buyers.² Such an impact is not foreseen on the European market but art collectors, in general, are known to place great emphasis on privacy. Sharing personal information may prove an unwelcome hurdle for some of them, which could impact not only European AMPs but also the global art market.

1. Financial Times, "Can the art world clean up its act?", 2020, <https://www.ft.com/content/a5beb8e2-5334-11ea-90ad-25e377c0ee1f>

2. Washington Post, "Mexican art galleries suffer as drug money laws end anonymous cash buys", 2014, https://www.washingtonpost.com/world/mexican-art-galleries-suffer-as-drug-money-laws-end-anonymous-cash-buys/2014/09/16/4e5dc6c4-3d41-11e4-a430-b82a3e67b762_story.html

WHO IS AFFECTED BY THE DIRECTIVE?

AMPs are defined in AMLD5 as firms or sole practitioners who are “trading or acting as intermediaries in the trade of works of art, including when this is carried out by art galleries and auction houses, where the value of the transaction or a series of linked transactions amounts to €10,000 or more” as well as “persons storing, trading or acting as intermediaries in the trade of works of art when this is carried out by free ports, where the value of the transaction or a series of linked transactions amounts to €10,000 or more”³.

Auction houses, galleries, art dealers, advisors, free-ports, art fairs, and any other intermediaries involved in an art transaction fall within the scope of AMLD5.

AMPs are, however, exempt from such obligations if the total value of a transaction or a series of linked transactions (including taxes, commission, and ancillary costs) falls below €10,000. One might wonder about the volume of transactions that will fall in the scope of AMLD5. Even though few artists ever reach the one million US dollar level, the global average auction lot price reached \$24,000 in 2019, with more than 550,000 transactions and a total turnover of \$13.3 billion.⁴ This only represents the tip of the iceberg, as the value of the global art market in its entirety was estimated to have reached \$64.1 billion that same year. It is, therefore, safe to assume that tens, if not hundreds, of thousands of transactions will fall under AMLD5 on an annual basis.

WHAT ARE THE REQUIREMENTS IMPOSED BY AMLD5?

Regardless of the size of the business, each AMP needs to implement a robust compliance framework, which must be appropriate for addressing the money laundering risks to which the business may be exposed. This principle of the risk-based approach lies at the core of any robust anti-money laundering framework.

Understanding the specific nature of these money laundering risks requires an overall risk assessment. These risks will be different for each business. For example, a French online art gallery selling the work of young artists for €1,000 on average, with occasional bigger pieces exceeding €10,000, will have a different risk profile to an auction house operating in Paris with an average sales price of above €100,000 and an international base of customers. Both will therefore have different internal controls.

Once the risks have been identified, a framework will generally include customer due diligence and transaction monitoring measures. The framework must be documented (e.g. policies, procedures, controls) and well-embedded within the entire organization (through training, awareness, etc). AMPs are also required to appoint a dedicated anti-money laundering compliance officer (AMLCO), and records of customer due diligence must be kept securely and remain available for scrutiny.

Finally, suspicious activity reports (SARs) must be sent to competent authorities when suspicious transactions are detected. For example, a client residing in Spain wishes to purchase an artwork from a local gallery, but uses funds from an account located in the Bahamas or immediately proposes to sell back the

3. Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018

4. Art Price, The Art Market in 2019, 2019, <https://www.artprice.com/artprice-reports/the-art-market-in-2019/global-assessment-strong-and-flexible-demand/>

purchased piece at a lower price. These unusual behaviors must be identified by the AMP as part of their standard transaction monitoring and may result in a SAR.

There is a lot at stake for AMPs who lack solid compliance frameworks. Failing to implement appropriate controls and

recordkeeping, may result in administrative fines of up to 10 percent of the previous year's turnover - or even criminal charges. However, in a market where reputation is key, reputational damage can have a more severe impact.

IMPACT ON THE CUSTOMER JOURNEY

The pressure to perform customer due diligence prior to the delivery of the artwork could jeopardize the customer journey and relationship. Indeed, AMLD5 requires the AMP to perform due diligence on the customer, the legal representative, and the ultimate beneficiary owner (UBO) for transactions of €10,000 or more.

The parties qualifying for due diligence will differ depending on each deal set-up. For example:

- An auction house is required to perform customer due diligence on both the buyer and the seller, as they both qualify as its customers;
- In the case of a private deal, where a gallery or an art dealer sells an artwork to a buyer, the customer due diligence should be performed on the buyer only;

If that same gallery or dealer sells an artwork to a buyer on behalf of a seller, the customer due diligence must also include the seller.

Due diligence typically consists of verifying the identity of all parties concerned. When dealing with an individual, valid identification documents (passport, identity cards, etc.) are required to confirm

the name, family name, date and place of birth and, if possible, their address. Similar corporate documentation (bylaws, trade registry, etc.) must be obtained when dealing with a legal entity to validate the corporate name, registered office, members of the board of directors, and the ownership and control structure. The checks must be performed following a risk-based approach, allowing for simplified due diligence on low-risk clients while requiring enhanced due diligence on high-risk clients.

AMPs must also perform checks on the source of funds and the nature of the transaction or business relationship. Specific measures must be taken where certain elements of high risk are detected, such as links to a high-risk country, tax havens, or politically exposed persons.

Complexity may arise in situations involving intermediaries. Most high-value transactions involve numerous intermediaries, especially when dealing with legal entities (trusts, museums, foundations, etc.), located in different parts of the world.

For example, a seller based in France hires an agent located in the UK to sell a *Concetto Spaziale* by Lucio Fontana at \$550,000. There is a lot of liquidity in the market for this type of work, which could make it a target for money launderers. On the other side

of the transaction, the buyer located in Italy uses the services of another agent, also located in Italy. That same agent is in contact with a third UK-based agent. The two UK-based agents then conduct the transaction on behalf of the ultimate buyer and seller. In this set-up, due diligence may need to be performed by three different agents on five different participants - a total of 10 different due diligence procedures⁵.

As complex as it may seem, these types of multilayered arrangements happen quite often with high-value transactions. This example also highlights the global impact of the Directive: the buyer and his agent would also be subject to customer due diligence if they are not based in the EU, since the seller and his agent are EU-based AMPs.

CAPCO'S PROPOSED APPROACH

The complexity of AMLD5 requirements will clearly put pressure on the art sector. As stated above, AMPs are used to doing business without much scrutiny of compliance measures. Implementing an anti-money laundering framework can be challenging for international structures established within and outside the

EU. Smaller businesses with no prior legal and compliance capabilities may – whether inadvertently or deliberately – fail to implement an AML framework, whether through a lack of awareness of AMLD5's importance and the potential sanctions they could face or due to the costs and complexity involved.

Building on existing capabilities and experience can help mitigate some of the challenges. Here are the four key areas to focus on to ensure successful compliance with AMLD5 requirements:

- 1. Keep your customer journey at the heart of your approach:** The information required under AMLD5 will lengthen sales processes and impact your client relationships. The increase in personal information disclosure will also impact customer experiences. Keep it simple: ensure that you design a framework that can be executed while focusing on the customer journey. Being compliant with the General Data Protection Rule (GDPR), building seamless due diligence processes and transparent communication channels can safeguard client relationships and differentiate you from the competition.
- 2. Safeguard your reputation: Your reputation is built on trust from your clients.** Art Tech firms offer tools to keep your client database secure, up to date and readily accessible, with a thorough monitoring process for both authentication and AML purposes. Should you identify a suspicious transaction, the availability of up to date client information and records will help you stop such a transaction while also allowing meaningful cooperation with relevant authorities. Remember the regulator's starting point: "What is not documented, does not exist". Your reputation is at stake, so do not make the mistake of underestimating the importance of a solid AML framework.

5. The seller's agent must conduct a due diligence on the seller (his client), on the buyer (UBO) and the agent of the buyer as well as on the intermediary agent. The buyer's agent must conduct a Customer Due Diligence on the buyer (his client), on the intermediary agent, and on the seller's agent. Note that the buyer and his agent have no obligation nor right to know the identity of the seller. The intermediary agent must conduct a Customer Due Diligence on both the buyer's and the seller's agents, as well as on the buyer (UBO).

- 3. Do not reinvent the wheel:** Repeating the process of providing personal information for different transactions and AMPs is tiresome and could discourage some collectors from trading actively. Establishing a central and secure registry of clients for AMPs could minimize the need for repeated individual disclosures of personal data; however it should be noted that collectors are not likely to welcome the idea of their identity being stored and shared among AMPs. You can use your existing client registry to get an overview of all the information already collected, keeping in mind that the information stored should be limited to what is necessary from an AMLD5 customer due diligence perspective, to remain GDPR compliant. This will allow you to identify gaps, avoid unnecessary workload, preserve client relationships, and align your AMLD5 and GDPR frameworks.⁶
- 4. Focus on your high risks:** A granular overall risk assessment will allow you to identify risks more precisely and prevent suspicious transactions. Allocate your valuable compliance resources to high risks rather than false positives.

Our experience in the financial sector and regulatory topics such as AML can help you adapt to your new compliance obligations. Capco can support you in turning these challenges into strategic opportunities by developing a strong compliance framework while focusing on your customer journey.

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6. Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) (Text with EEA relevance)

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