Spotting Red Flags Of Illicit Activity In High-End Art Sales

By **Peter Hardy, Terence Grugan and Shauna Pierson** (April 10, 2023)

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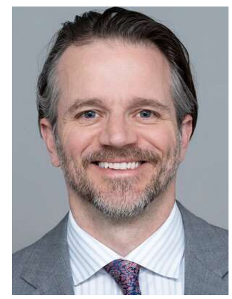

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The potential use of high-end art and antiquities to launder money and evade sanctions has attracted more attention over the last several years, particularly as the prices for such objects rose and a tightening global enforcement and regulatory net rendered other avenues for money laundering less attractive.

These issues were examined in a report issued by the Financial Action Task Force, based on their recent plenary session in Paris.[1] The FATF is an international body aimed at setting policies that enable governments to more effectively combat money laundering, terrorist financing and related crimes.

The FATF also monitors how effectively governments implement anti-money-laundering tactics and efforts to combat the financing of terrorism through annual evaluations of its members.

According to the FATF,

> The trade in high value works of art and antiquities can attract criminals who seek to exploit the sector's history of privacy and the use of third-party intermediaries to launder the proceeds from drug trafficking, corruption and other crimes.

The report sets forth risk indicators that can help private and public entities identify suspicious transactions relating to art and antiquities.

The FATF's concerns echo similar concerns expressed in recent years by the U.S. Department of the Treasury's Financial Crimes Enforcement Network, which issues anti-money-laundering regulations under the Bank Secrecy Act, and the Office of Foreign Assets Control, which administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals.

As we will discuss, FinCEN has yet to issue proposed BSA regulations for the trade in antiquities. Although FinCEN has indicated that it will not issue BSA regulations in the near future for the art industry, both FinCEN and OFAC have stressed that high-end art continues to be a potential instrument for evading sanctions, particularly those relating to Russia.

To comply with their AML compliance requirements under the BSA to detect and report potentially illicit activity by customers, and to comply with U.S. sanctions law, financial institutions that cater to customers in the art and antiquities world must have systems in place that are attuned to the particular risks presented by these industries. To that end, the FATF report identifies potential red flags for financial institutions and others attempting to identify suspicious activity in the trade of art and antiquities.

As we will detail below, FinCEN also has described similar red flags for financial institutions to consider when onboarding such customers and monitoring their account transactions.

However, and as we also discuss, it can be extremely difficult as a practical matter for financial institutions to identify potential money laundering and sanctions violations in art and antiquities transactions. Indeed, doing so is often very challenging even for the auction houses and galleries involved directly in purchases and sales.

Nonetheless, financial institutions have no choice but to remain on guard — and be especially vigilant about the potential evasion of sanctions, because sanctions are currently an area of intense criminal and regulatory enforcement focus, and because violations can involve severe penalties even if financial institutions lack actual knowledge that prohibited transactions occurred.

The FATF Report

According to the report, illicit funds laundered through the art and antiquities world include the proceeds of corruption, drug trafficking and financial crimes. Typical money laundering methods include hiding or transferring illicit proceeds by concealing the identity of the true buyer, under- or over-pricing items, and using fake sales or auctions.

Art and cultural objects can be attractive vehicles for money laundering because they tend to attract high prices and retain their value, and can be transferred discreetly between people and businesses and across borders.

In addition to serving as vehicles to launder the proceeds of independent schemes, art and antiquities can be involved in offenses directly related to those markets, such as art forgery, fraud, theft and illegal trafficking.

Further, the markets for cultural objects can be vulnerable to exploitation by terrorist financing. Transnational organized crime groups have occasionally cooperated with terrorists to acquire such items and smuggle them out of conflict areas.

The report stresses that auction houses, dealers, galleries and art finance service providers must know how to recognize suspicious activity and conduct appropriate enhanced due diligence if questions arise about the source of funds or the unusual structuring of transactions.

These steps will be even more difficult for financing institutions that provide banking services for these industry participants, because they are even further removed from the transactions. And the report acknowledges that private sector actors often lack complete information, including information available to law enforcement.

With that major caveat, Annex A to the report includes a lengthy list of risk indicators that private — and government — actors such as financial institutions can use to identify suspicious activities associated with art and cultural objects, such as:

- Use of shell companies, trusts, or third-party intermediaries, including art dealers, brokers, advisers, or interior designers, to purchase, hold, or sell cultural objects.

- Unusually high profit margins on the sale of an item of art, antiquity or other cultural objects. ... [Likewise,] sales or purchases vastly or routinely exceeding the expected sales value of the work.

- Sales or purchases of items involving sellers who are not concerned with recouping their initial investments.

- Sales or purchases of art where a client is not familiar with, or interested in, the provenance, history, style, genre, or artist of an object.

- Presence of natural or legal persons known to be involved in, or suspected of, trafficking in cultural objects.

- Transactions involving politically exposed persons (PEPs), their family members or close associates.

AML Regulation of the Art and Antiquities Trades in the U.S.

In the U.S., Congress already has subjected antiquities dealers to anti-money laundering duties. The Anti-Money Laundering Act amended the BSA's definition of "financial institution" to include those

> engaged in the trade of antiquities, including an advisor, consultant, or any other person who engages as a business in the solicitation or the sale of antiquities, subject to regulations prescribed by the [Treasury] Secretary.[2]

Accordingly, FinCEN issued an advance notice of proposed rulemaking on Sept. 24, 2021, to solicit comment on the implementation of AML rules in the antiquities market.[3] FinCEN has yet to implement regulations for antiquities dealers. This February it indicated that such regulations are a long-term project with an expected completion date still to be determined.[4]

There will not be any direct BSA regulation of the art trade — an industry far larger than the antiquities trade — any time soon, either.

On Feb. 4, 2022, the U.S. Department of the Treasury published a study on the facilitation of money laundering and terrorist financing through the trade in works of art.[5]

The study concluded that "the art market should not be an immediate focus for the imposition of comprehensive AML/[countering the financing of terrorism] requirements," primarily because FinCEN already has its hands full trying to fulfill the many other dictates imposed on it by the Anti-Money Laundering Act and related developments. These include the Corporate Transparency Act[6] and potential regulations for the real estate industry[7] and investment advisors.

The study walks through the ways that art market participants, including auction houses, galleries, online marketplaces and art finance companies, are vulnerable to illicit activities. To summarize, the study finds that galleries present the lowest AML/CFT risks, relatively speaking.

However, the study notes that the emerging online art market may present new risks, particularly risks involving non-fungible tokens, which are digital units on an underlying blockchain that can represent ownership of a digital work of art. Online markets also present heightened risk because of the difficulty vendors may have verifying customer identities.

Finally, the study finds that art finance companies and other market institutions providing financial services in the art market through lending and financing options, such as art-collateralized loans, are typically not subject to AML or CFT program requirements and can be vulnerable to money laundering because asset-based lending can be used to disguise the original source of funds.

Presumably, financial institutions can use the findings in the study to fine-tune their risk assessments of art and antiquities customers, and decide whether those customers should be subject to enhanced due diligence during onboarding or subsequent transaction monitoring.

The study also emphasizes the role of corrupt third parties — specifically, the risk that illicit actors may manipulate or bribe merchants, financial services employees or other professionals to circumvent policies and best practices to consummate a transaction. According to the study, a significant portion of money laundering in the high-value art market occurs with the help of complicit professionals. Further, the historically private nature of the high-value art market makes it difficult for authorities to identify and investigate potential money laundering.

If these problems bedevil government investigators, surely financial institutions face even greater challenges in implementing AML compliance programs and attempting to identify suspicious transactions. Nonetheless, the study suggests that certain high-value transactions by third-party professionals could be subject to additional scrutiny from financial institutions in the form of potential account closures or the filing of suspicious activity reports.

The study makes several recommendations for mitigating money laundering risks in the art industry. In part, the study emphasizes that implementing targeted record-keeping and reporting requirements under the BSA could help support information collection and enhanced due diligence, which could discourage criminals from attempting to launder illicit funds through the institutional art market.

For example, FinCEN could request that certain covered businesses provide the identity of natural persons that are purchasing art. Obviously, this would be similar to the Corporate Transparency Act reporting requirements, which will become effective on Jan. 1, 2024.[8]

It may be years until some portion of the art industry is subject to direct BSA regulations. But the issue is not going to disappear, and financial institutions and art market participants still need to navigate current, real-world risks created by specific transactions that may involve money laundering schemes.

Regardless of when direct BSA regulations will apply to the art world, the criminal statutes against money laundering remain in effect.[9] What this means is that financial institutions and art industry participants must not willfully ignore the fact that a transaction of any nature involves the proceeds of previous criminal activity. The same is true for the laws regarding sanctions, to which we now turn.

Art, Sanctions and Russia

In July 2020, the Permanent Subcommittee on Investigations for the U.S. Senate released a detailed report focusing on the potential nexus between high-end art and U.S. sanctions law violations, money laundering schemes and AML risks.[10]

Shortly thereafter, as if on cue, OFAC issued an October 2020 advisory highlighting the related problem of individuals blocked by OFAC trying to evade those restrictions through the commerce of art.[11] The advisory echoed many of the same concerns previously described: that the art market possesses unique features that make it vulnerable to exploitation by illicit actors.

These features include a lack of transparency and high degree of anonymity, coupled with the subjectivity of the value of art, which allows high financial investments in given pieces of art without raising suspicion, unlike other high-end products and expenditures that generally have an ascertainable value. Accordingly, says the Senate report: "The mobility, concealability, and subjective value of artwork further exacerbates its vulnerability to sanctions evasion," particularly through cross-border transactions.

In the aftermath of the Russian invasion of Ukraine in February 2022, the spotlight on the potential use of art and other high-value assets to evade sanctions has only intensified. Most recently, FinCEN issued in December 2022 a financial trend analysis regarding BSA filings — primarily, suspicious activity reports — from March to October 2022, which reflected financial activity by Russian oligarchs at the time of Russia's invasion.[12] FinCEN found that

> BSA data filed on financial transactions of Russian oligarchs, high-ranking officials, sanctioned individuals, and their family members in 2022 showed patterns indicative of corruption and sanctions evasion, including the movement or transfer of funds or ownership of assets and trusts; the purchase of high-value goods or property; and changes in financial flows with links to property or companies in the United States.

One of the overall conclusions in the trend analysis is that several oligarchs purchased high-value goods, including art, jewelry and real estate in other countries leading up to the invasion.

FinCEN noted this behavior in a March 2022 alert, "Real Estate, Luxury Goods, and Other High Value Assets Involving Russian Elites, Oligarchs, and their Family Members."[13] The alert reiterates the need for increased vigilance by financial institutions in detecting suspicious transactions that may be seeking to evade sanctions through transactions involving high-value assets such as art, real estate, and precious metals and stones.

To that end, the alert provides guidance to financial institutions on how to identify suspicious transactions relating to the use of high-value assets by Russian elites, their family members and their so-called proxies.

Specific to the art trade, the alert sets forth the following potential red flags, many of which are similar to the more general red flags set forth by the FATF report:

> 7. The use of shell companies and trusts, and/or third-party intermediaries, including art dealers, brokers, advisers, or interior designers, with a nexus to sanctioned Russian elites and their proxies, to purchase, hold, or sell art on a client's behalf.
>
> 8. Transactions involving sanctioned Russian elites and their proxies, and large amounts of cash, especially in currencies not typically used in the art market.
>
> 9. Artwork-related transactions involving persons with suspected ties to sanctioned Russian elites and their proxies who (i) are not concerned with recouping their initial

investment or paying a substantially higher price than the notational value of the work, and/or (ii) conduct transactions that exceed the expected sales value of the work.

10. The purchase, maintenance, or termination of insurance policies to protect the market value or provide cash payments for the loss, theft, or destruction of privately held or donated high-value artwork linked to sanctioned Russian elites and their proxies.

However high-level these red flags may be, they at least provide a starting point for navigating a difficult area that is attracting increasing interest from both regulators and law enforcement. Further, they can apply equally to financial institutions and those directly involved in the sale of art and antiquities.

Until FinCEN proposes regulations for the antiquities trade, and potentially for the art trade, publications like the alert, coupled with internal AML compliance plans and industry group guidance, will have to suffice for those assessing the risks of specific sales.[14]

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[1] Fin. Action Task Force, Money Laundering and Terrorist Financing in the Art and Antiquities Market (Feb. 27, 2023), https://www.fatf-gafi.org/en/publications/Methodsandtrends/Money-Laundering-Terrorist-Financing-Art-Antiquities-Market.html.

[2] The Anti-Money Laundering Act of 2020 is Titles LXI-LXIII, LXV of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Public Law 116-283 (Jan. 1, 2021).

[3] FinCEN, Anti-Money Laundering Regulations for Dealers in Antiquities, 86 Fed. Reg. 53021 (Sept. 24, 2021), at https://www.federalregister.gov/documents/2021/09/24/2021-20731/anti-money-laundering-regulations-for-dealers-in-antiquities.

[4] U.S. Department of the Treasury, Semiannual Agenda and Regulatory Plan, 88 Fed. Reg. 11278, 11281 (Feb. 22, 2023), https://www.govinfo.gov/content/pkg/FR-2023-02-22/pdf/2023-02032.pdf.

[5] U.S. Department of the Treasury, Study of the Facilitation of Money Laundering and Terror Finance Through the Trade in Works of Art (Feb. 4, 2022), https://home.treasury.gov/system/files/136/Treasury_Study_WoA.pdf.

[6] The Corporate Transparency Act (CTA) is Title LXIV of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Public Law 116-283 (Jan. 1, 2021). Very generally, the CTA requires defined entities — including most domestic corporations and foreign entities registered to do business in the United States — to report beneficial owner information and company applicant information to a database created and run by FinCEN upon the entities' creation or registration within the United States. To the extent that transactions in art occur through legal entities, the CTA will affect the art trade.

[7] See FinCEN, Anti-Money Laundering Regulations for Real Estate Transactions, 86 Fed. Reg. 69589 (Dec. 8, 2021), at https://www.govinfo.gov/content/pkg/FR-2021-12-08/pdf/2021-26549.pdf.

[8] See supra note vii.

[9] 18 U.S.C. §§ 1956, 1957.

[10] U.S. Senate Permanent Subcommittee on Investigations, The Art Industry and U.S. Policies That Undermine Sanctions (July 29, 2020), https://www.hsgac.senate.gov/wp-content/uploads/imo/media/doc/2020-07-29%20PSI%20Staff%20Report%20-%20The%20Art%20Industry%20and%20U.S.%20Policies%20that%20Undermine%20Sanctions.pdf.

[11] OFAC, Advisory and Guidance on Potential Sanctions Risks Arising from Dealings in High-Value Artwork (Oct. 30, 2020), https://home.treasury.gov/system/files/136/Treasury_Study_WoA.pdf.

[12] FinCEN, Financial Trend Analysis — Trends in Bank Secrecy Act Data: Financial Activity by Russian Oligarchs in 2022 (Dec. 22, 2022), https://www.fincen.gov/sites/default/files/2022-12/Financial%20Trend%20Analysis_Russian%20Oligarchs%20FTA%20_Final.pdf.

[13] FinCEN, FinCEN Alert on Real Estate, Luxury Goods, and Other High-Value Assets Involving Russian Elites, Oligarchs and Their Family Members, FIN-2022-Alert002 (March 16, 2022), https://www.fincen.gov/sites/default/files/2022-03/FinCEN%20Alert%20Russian%20Elites%20High%20Value%20Assets_508%20FINAL.pdf. This alert drew upon a related, more general publication issued by FinCEN only one week earlier. See FinCEN, FinCEN Advises Increased Vigilance for Potential Russian Sanctions Evasion Attempts, FIN-2022-Alert001 (March 7, 2022), https://www.fincen.gov/sites/default/files/2022-03/FinCEN%20Alert%20Russian%20Sanctions%20Evasion%20FINAL%20508.pdf.

[14] For example, the AML Standards for Art Market Operators (AML Standards) are set forth by the Basel Institute on Governance, an independent not-for-profit organization. Basel Inst. on Governance, Basel Art Trade Anti-Money Laundering Principles (Jan. 2018), https://baselgovernance.org/sites/default/files/2019-01/Basel%20Art%20Trade%20AML%20Principles%202018.pdf. The AML Standards are intended to apply to those trading in art, and intermediaries between buyers and sellers. They suggest that service industries supporting the art trade that are already subject to AML laws, like financial institutions, should identify their customers in the art trade "as higher risk as long as there are no internationally applicable standards."

Likewise, the Responsible Art Market, an industry-supported not-for-profit organization, provides both an Art Transaction Due Diligence Toolkit and Guidelines on Combatting Money

Laundering and Terrorist Financing. Responsible Art Market, Art Transaction Due Diligence Toolkit (2018), http://responsibleartmarket.org/wp/wp-content/uploads/2018/01/RAM-DUE-DILIGENCE-web.pdf; Responsible Art Market, Guidelines on Combatting Money Laundering and Terrorist Financing, http://responsibleartmarket.org/guidelines/guidelines-on-combatting-money-laundering-and-terrorist-financing/?print=pdf. The AML Guidelines are similar to the protocols set forth by the Basel Institute, but provide slightly more concrete detail.