STEPHENSON HARWOOD

Art law – recent developments

May 2019 issue

Welcome to the latest issue of our "Art law - recent developments" newsletter in which we discuss legal issues currently affecting the global art community.

In this issue we look at:

Return to sender? Falling foul of cybercrime

The risk of being a victim of cybercrime can often be overlooked or underestimated in the art market. However, as artists, galleries and museums increase their reliance on online sales and the use of email to conduct and agree transactions, the opportunities for hackers to strike have never been greater.

It's a situation sellers know well. A potential purchaser contacts an artist or gallery asking to purchase an artwork and, after an email exchange, a price is agreed. Thereafter an invoice is emailed to the purchaser, who duly affects a bank transfer. The artwork passes to the purchaser.

However, what if, unbeknown to the seller and the purchaser, a hacker has infiltrated their email traffic and has manipulated the content of their emails, so that the purchaser receives an electronic invoice purportedly from the artist or gallery, but the payment details have been replaced with the hacker's own account details? Alternatively, what if an irate artist emails a gallery chasing payment for an artwork and the gallery rushes through the payment, without spotting that they had, in fact, been contacted by an alternative email address and the sums paid to a fraudster? Such situations can lead to monetary losses, data protection issues and PR disasters.

The art market can be particularly vulnerable to such attacks, with hackers aware that large sums of money will eventually be changing hands and that those operating in this sphere may underestimate the need for robust (and maintained) cyber protection. There is also a wider value to be gained from accessing a gallery or art institution's servers, with the identity of a gallery's customers or an institution's benefactors potentially being of considerable value.

Prevention is better than cure

We all protect our physical assets – doors are locked and alarms are set. However, in the increasingly digitalised world, we can be more lax in protecting access to our electronic data. Personalised user

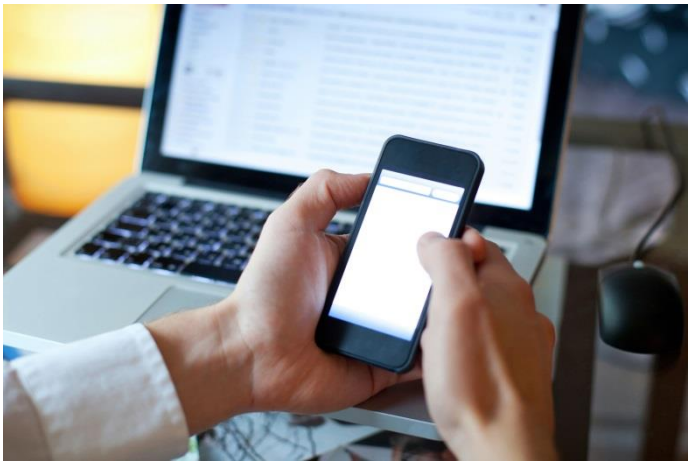
accounts and private passwords, together with anti-virus and security software, are important tools for anyone conducting business electronically. However, they can often be undermined, with passwords shared and out of date software not replaced.

The importance of maintaining these protections can often be overlooked where there is no obvious evidence that email servers have been attacked. However, hackers will often sit dormant within a compromised server, watching email traffic and waiting for their moment to strike, usually when money is to be paid. Complacency now may well lead to issues later on.

As well as ensuring that robust cybersecurity measures are implemented and maintained, being aware of potential 'red flags' may also save you from making a costly mistake. For example, having identified the basic details of a sale, fraudsters may set up a near-on identical email address and open a line of communication, in an attempt to make the purchaser divert the purchase price to an alternative bank account. In the world of overflowing inboxes, minor changes to an email address may be overlooked, but a simple call to the purchaser to confirm bank details (using contact details previously obtained) can put your mind at ease. Similarly, receiving updated or amended invoice details midway through a transaction may well be legitimate but can often be a sign that something is amiss and that further confirmation is required. Staff training and regular reminders to be alert to the possibility of cybercrime may mean that they are more likely to be alert to situations where something 'isn't quite right'. The time spent making a telephone call to double check details with a third party may save you from making a costly mistake.

Acting fast to maximise recovery

If you believe that you have been the victim of cybercrime and transferred sums to a fraudster, you must act quickly if you are to attempt to recover some or all of the sums that have been lost. As well as notifying the police, legal advice should be urgently obtained as to whether it is possible to freeze the recipient bank account and recover the transferred sums. Whilst fraudsters may immediately empty bank accounts once sums have been obtained, slow bank transactions and clearing processes may provide you with a very short window in which to freeze the transferred sums. You may also wish to consider invoking a temporary moratorium on paying all pending invoices whilst those invoice details are double checked, to ensure that further transactions have not been compromised.



As well as taking steps to recover the transferred sums, it is vital to establish how the fraudster was able to bypass cyber security systems or was otherwise able to redirect payment. You will also need to check whether any other transactions have been compromised. This information will be crucial in formulating a strategy going forward, from managing the PR of a potential data breach to complying with the reporting requirements under data protection legislation.

Preparation, preparation, preparation

As with other potential threats, preparation is key. Careful consideration as to how a potential cybercrime event would be dealt with and establishing a process to be followed is likely to save precious time if the situation ever arose, and may well increase your chances of recovering any lost sums.

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The Fifth EU Money Laundering Directive and the art market

Despite fierce resistance from the art world, January 2020 is likely to see the Fifth EU Money Laundering Directive take effect in the UK, requiring auction houses and art dealers to undertake anti-money laundering checks on customers. Establishing systems to carry out such checks will carry significant resourcing implications, and any failure to undertake checks with sufficient rigor can attract criminal penalty, for both institutions and their directors.

Background

Anyone who has opened a bank account, bought a house or instructed a solicitor will have experienced anti-money laundering checks.

Typically, as a new customer of a firm that is subject to the Money Laundering Regulations, you will need to provide evidence of your identity, in the form of a passport, driving licence and / or recent utility bill. Such identity checks – called "Know Your Client" or "KYC" checks – have been mandatory for financial and credit institutions since the first European Money Laundering Directive entered into force in the UK in 1993.

From 2007 the implementation of the Third Money Laundering Directive extended KYC obligations to lawyers, accountants, real estate agents and so-called "high value dealers" (on which see below).

In January 2020, the entry into force of the Fifth Money Laundering Directive will bring art dealers and auction houses into the regulated sector for anti-money laundering ("**AML**") purposes.

The current position

The Fourth Money Laundering Directive entered into force in the UK as recently as June 2017. As was the case under the predecessor (2007) Money Laundering Regulations, art dealers and auction houses are not specifically within scope of the Regulation.

At present, the only way an art dealer or auction house is likely to fall within the scope of the regulations is as a so-called "high value dealer", a concept which was expanded in the 2017 Regulations to include:

- any firm or sole trader;
- who by way of business trades in goods, including an auctioneer dealing in goods;
- when the trader makes or receives, in respect of any transaction, a payment or payments in cash of at least 10,000 euros in total;
- whether the transaction is executed in a single operation or in several operations which appear to be linked.

An auction house or art dealer who meets the definition of a "high value dealer" is obliged under the 2017 Regulations to put in place a system of policies, procedures and training, all based on a documented money laundering risk assessment, to ensure customers' identities are checked and (in higher risk cases) verified.

Aside from the Money Laundering Regulations any art dealer, whether a "high value dealer" or not, may be required to report suspicions of money laundering to the National Crime Agency, in order to avoid criminal liability for money laundering.

We recently advised an art dealer who was approached by email in respect of a work which was offered for sale on the firm's website. The potential buyer was not known to the dealer, did not ask the sort of questions one would expect a purchaser of a high-value work to ask, and wanted to pay for the piece by way of a series of electronic transfers from a high-risk jurisdiction. The dealer in this case suspected that the buyer may be attempting to launder money. Had the dealer received the money, having formed a suspicion, s/he may have committed a criminal offence of money laundering under the Proceeds of Crime Act 2002. In the event, we advised the dealer make a report to the National Crime Agency, which created a defence to the criminal offence of money laundering.

The Fifth Money Laundering Directive and (likely) position in the future

The Fifth EU Money Laundering Directive was formally adopted by the European Parliament in April 2018. EU Member States have until 10 January 2020 to give effect to its provision.

The Fifth Regulation amends the Fourth Regulation to include the following within the definition of "obligated entities":

- *"persons 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 EUR 10 000 or more".*

Noteworthy is the fact that the monetary threshold is not limited by payment type. So any art dealer or auctioneer, trading in works of art valued at €10,000 or more, will be caught, whether they are paid by cash, cheque, bank transfer, or otherwise.

Despite uncertainty as to the nature and legal status of the UK's relationship with the European Union after 31 October 2019, the UK has committed to adopting the Fifth Money Laundering Directive along with the rest of Europe, either as part of the proposed transitional arrangement or some other deal which requires regulatory convergence in return for preferential access to the Single Market.

Even in the event of a "no deal" outcome, the UK – as a leading member of the Financial Action Task Force on Money Laundering (which sets the standards which underpin EU anti-money laundering law) – is unlikely to let UK AML standards fall behind those applicable elsewhere in Europe. This much was acknowledged by the Department for Business, Energy and Industrial Strategy in a widely-reported letter to Margaret Hodge MP in July 2018.

So when the Fifth Money Laundering Directive takes effect in January 2020, how will art dealers and auction houses be affected, and what can be done to prepare?

Practical Implications and Preparations

As indicated above, compliance with the money laundering regulations require a significant commitment of resources and exposes a firm – along with its directors and officers – to potential criminal liability for any compliance failing.

Should the 2017 Regulations be extended to cover art dealers and auction houses, the following (non-exhaustive) list of requirements will apply:

Policies and Procedures:

- Regulated firms must register with the relevant supervisor (at present, for High Value Dealers, this is HMRC);
- Regulation 18 of the 2017 Regulations requires firms to conduct a Money Laundering Risk Assessment, which considers specific heads of risk – customer, geographic, products, transactions and delivery channels – when carrying out the risk assessment;
- Once drafted, the 2017 Regulations envisage the Risk Assessment as fundamental to day–to-day conduct of a "risk based approach" to compliance;
- Regulation 19 of the 2017 Regulations clearly envisages that AML policies and procedures will be drafted with reference to the risk assessment;
- The 2017 Regulations also specifically mandate that "the ways in which a relevant person complies with the requirement to take customer due diligence measures, and the extent of the measures taken must reflect the risk assessment carried out by the relevant person under regulation 18(1)" (Regulation 28(12) 2017 Regulations).

Customer Due Diligence:

- When entering into a relationship / transaction, Customer Due Diligence ("**CDD**") must be conducted to identify the customer;
- Unlike the 2007 Regulations, the 2017 Regulations do not allow any automatic departure from CDD requirements, based on customer type alone. Instead, firms will be able to "adjust the extent" of CDD measures where a business relationship / transaction is determined to present a lower risk of money laundering.
- The 2017 Regulations also expand on the 2007 Regulations by requiring the application of Enhanced Due Diligence Measures ("**EDD**") where:
  - a transaction or business relationship involves "a person established in a high risk third country" (as defined by the European Commission); or
  - the customer is a Politically Exposed Person ("**PEP**") "or a family member or known close associate of a PEP" including a domestic PEP (Regulation 35, 2017 Regulations).
- The Fifth Money Laundering Directive adds to the existing list of "higher risk situations" (which require the application of EDD):
  - "*transactions related to… cultural artefacts and other items of archaeological, historical, cultural and religious importance, or of rare scientific value, as well as ivory and protected species*."

Training and "Screening" of Employees:

- The 2017 Regulations will create an obligation on larger firms to conduct initial and periodic "screening" of "relevant employees" (Regulation 21(1)(b) 2017 Regulations);
- "Relevant employee" is defined to catch not only compliance staff, but also employees in the front

office, who introduce business and engage with clients;
- Screening of relevant employees means an assessment of the skills, knowledge and expertise of the individual to carry out their functions effectively, and the conduct and integrity of the individual.

Checks on Intermediaries:

- Of particular relevance to the art market is Regulation 38(10) of the 2017 Regulations, which requires verification checks to be undertaken in respect of any intermediary who is making a purchase on behalf of somebody else.

Consultation Paper on the transposition of Fifth EU Money Laundering Directive

Regardless of the outcome of Brexit, the extension of the AML regulation to encompass art market participants remains likely. A Consultation Paper on the extension was published by HM Treasury on 15 April 2019, providing an opportunity for auction houses and art dealers to offer views and seek clarifications where necessary. For example, views are sought on a number of scenarios that demonstrate the difficulties in practically applying the Regulations, including the application of CDD measures to auctions where the buyer and final sale price may not be known until the sale has concluded.

An interesting point of consultation is whether the scope of "art intermediaries" should be widened to other intermediaries that are not making or receiving the payment. This would extend the obligations and liabilities under the Fifth EU Money Laundering Directive to other professionals within the art market including art curators, consultants, appraisers, and specialists in art storage and shipment.

The Consultation Paper also identifies HMRC as a likely supervisor, given that the tax authority already supervises high value dealers. HMRC, together with the Office of Professional Body Anti-Money Laundering Supervisors, has taken a notably active role in the prevention and sanctioning of money-laundering offences. However, in a recent report on anti-money laundering supervision and sanctions implementation, the Treasury Committee queried whether HMRC should retain its AML supervisory role. Such a move would allow the authority to focus on its tax responsibilities and create a more centralised AML supervisory landscape.

Conclusions

Regardless of the outcome of Brexit, the extension of the AML regulation to encompass art market participants remains likely. A Consultation Paper on the extension will likely be published by HM Treasury in the summer or autumn of 2019, at which point the precise nature and extent of the obligations that will apply to auction house and art dealers will become clear. Importantly, such firms will have an opportunity to respond to any Consultation, offering views and seeking clarifications where necessary.

Establishing a compliance system to meet the Money Laundering Regulations is no easy undertaking. Given that the Regulations could be extended to auction houses and art dealers as soon as January 2020, such firms would be well advised to begin to consider how the requisite elements of compliance – risk assessment policies, CDD measures, training – will be built into their business and given effect.

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Ivory Act 2018 – a political triumph at the art market's expense?

Amidst government deadlock on Brexit, one piece of legislation did manage to sail serenely through the parliamentary process.

The Ivory Act 2018 (the "**Act**") received Royal Assent on 20 December 2018 and is expected to come into force later this year. The Act introduces a near total-ban on the trade of ivory and has been hailed a "*landmark in our fight to protect wildlife and the environment*" by Environment Secretary Michael Gove.

The Act has, however, caused some consternation in the art market, particularly amongst dealers in antique ivory who are concerned their businesses will crumble.

What is banned?

The Act introduces a ban on "*dealing*" in items containing elephant ivory within the UK.

"*Dealing*" includes buying, selling and hiring ivory, offering or arranging to buy, sell or hire it, or keeping it for sale or hire. It also includes exporting it from or importing it into the UK for sale or hire.

Are there any exceptions?

The Act carves out the following categories of objects which are exempt from the ban:

- *Objects with a small amount of ivory*

  The so-called "*de minimis*" exemption applies to objects which contain less than 10% of ivory by volume and were made prior to 1947.

- *Rarest and most important objects*

  Pre-1918 items of outstandingly high artistic, cultural or historical value will also be exempt. In determining whether an object falls within this category, the rarity of the item and the extent to which the item is an important example of its type will be taken into account.

- *Musical instruments*

  The instruments must be pre-1975 and contain less than 20% of ivory by volume.

- *Portrait miniatures*

  This applies where the portrait miniature is pre-1918 and has a surface area of no more than 320cm².

In order to enjoy the benefit of the above exemptions, the owner of the item must obtain an exemption certificate from the government before buying, selling or hiring the item.

What are the penalties?

Anyone who directly breaches the prohibition on dealing ivory, or causes or facilitates a breach, commits an offence under the Act.

The Act provides for a range of criminal and civil sanctions including a maximum sentence of up to 5 years' imprisonment, an unlimited fine or both.

How will this affect museums?

The Act focusses on the dealing of ivory, so the Act should have little effect on ivory works which are already in museums' collections (unless of course they wish to de-accession).

Importantly, the Act also contains a further exemption for sales to and between "*qualifying museums*". This applies to museums accredited by the Arts Council England, the Welsh Government, the Scottish Government or the Northern Ireland Museums Council in the UK, or, for museums outside of the UK, the International Council of Museums.

As was the case before the Act was passed, any impact on museums will likely be confined to reputational (rather than legal) ramifications. By way of recent example, there was no law preventing the British Museum from accepting a donation of 500 Chinese ivory figures in June last year, but it was forced to defend itself to the press after a wave of negative publicity.

How will this affect dealers?

Dealers have expressed dismay at the stringent restrictions contained in the Act, arguing that it will do little to stop the trade in poached ivory but potentially render vast quantities of artworks and cultural objects unsellable. As one dealer queried in the Antiques Trade Gazette, "*I cannot see how one elephant alive today will be saved by me not being able to sell this chess set*".

Organisations including LAPADA (the Association of Art & Antiques Dealers) and BADA (the British Antique Dealers' Association) lobbied the government in the consultation process. Their concerns included:

- The level of the "*de minimis*" threshold. It was argued (unsuccessfully) that this should be raised to 50% for cultural objects made of ivory as 10% was so low that, for example, almost every object with a solid ivory handle would fall foul; and
- The bar for the "*rarest and most important*" exemption seems unreasonably high, and will not assist those trading in low-value objects (such as ivory crucifixes, Japanese netsuke and African carvings) which, whilst important, are not necessarily museum-quality.

How will this affect private collectors?

The prohibition applies only to "*dealing*" (buying, selling or hiring ivory). The Guidance Notes to the Act make clear that the prohibition will therefore not affect private collectors to the extent that they own, inherit, gift, donate or bequeath items made of or containing ivory.

If a private collector wishes to sell an ivory item in their collection, they will likely be restricted to selling to a qualifying museum (unless another exemption in the Act applies). There is therefore a strong possibility that pieces which do not meet museum standards will effectively be rendered unsellable. The resulting impact on value, for example in the context of an estate, should not be ignored.

What's next?

It is anticipated that the Act will come into force in late 2019 once necessary secondary legislation is passed, the online registration system for exempt objects is developed and guidance has been issued.

A further consultation is also due to take place on the extension of the elephant ivory ban to include hippopotamus, walrus and narwhal ivory.

As for the Act's impact on the art market, the conversation might not yet be over. The Antiques Trade Gazette reported in January that BADA, LAPADA, the Antiquities Dealers' Association and auctioneer body SOFAA are stepping up their plans for a judicial review. The trade bodies encouraged their members to take part in a survey to assess the economic impact of the Act. This is intended to form the basis of a legal challenge.

It appears that, despite the ease with which it was passed, there will be a few more hurdles before the Act can take effect.

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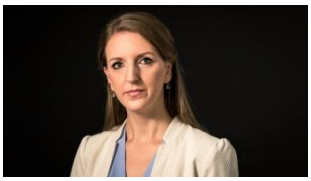

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Stephenson Harwood's art team wins Legal 500 award

Stephenson Harwood's art team has won the 'Private Client Firm (specialism) of the Year' award at The Legal 500 UK 2019 Awards, in recognition of its work in the art and cultural property sector.

This accolade follows the team's Band 1 ranking in The UK Legal 500 last October. The awards, which represent the very best law firms, chambers, silks, in-house lawyers, business leaders and general counsel operating within the UK market, are based solely on research by The Legal 500 and interviews with in-house counsel and law firms. We are delighted to have been recognised in this way.

‘Stephenson Harwood fields a ‘very well-respected and market-leading team that provides great customer service, very good representation and high levels of advice with a great ability to adapt quickly as needed.’

Legal 500 UK, 2019

Stephenson Harwood is a law firm with over 1100 people worldwide, including more than 180 partners. Our people are committed to achieving the goals of our clients - listed and private companies, institutions and individuals.

We assemble teams of bright thinkers to match our clients' needs and give the right advice from the right person at the right time. Dedicating the highest calibre of legal talent to overcome the most complex issues, we deliver pragmatic, expert advice that is set squarely in the real world.

Our headquarters are in London, with ten offices across Asia, Europe and the Middle East. In addition we have forged close ties with other high quality law firms. This diverse mix of expertise and culture results in a combination of deep local insight and the capability to provide a seamless international service.

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