

arcarta

Online AML Training

Art Market Anti-Money Laundering &
Financial Crime Prevention Training

Section 2:

What is Due Diligence?

- ID&V, KYC & CDD
- Positive information and definitions
- Negative information and definitions
- Fraud
- When to carry out CDD
- Levels of CDD - Simplified, Standard and Enhanced

What is Due Diligence?



If you've ever received an enquiry from an unknown client and have Googled them, you're actually carrying out a very low-level form of customer due diligence.

The reasons you may 'Google' a client, could be many and varied, though will likely include:

- The clients ***'buying potential'***
- Concerns around possible risks or the potential for ***'foul play'***

A Google search will help you to build up a picture of the person you are dealing with - leading to one goal: ***confidence***.

Often there are times when a Google search will be inconclusive, and it is important to note that a Google search alone is not sufficient to satisfy your obligations as a regulated Art Market Participant.

As it is a process, there is no 'definitive' or exhaustive procedure as to how to tackle or satisfy 'Customer Due Diligence'. Subsequently, you'll likely encounter different points of view - perhaps a colleague has their own unique ideas.

Matters are often confused further, as many Art Market Participants deal with well known clients throughout the course of business.

The view may be held that they are so well known to you personally and/or professionally - perhaps so well known to the market - that all you need to do is ask for a form of identification, such as a passport.

It can quickly become confusing as to what exactly is required to comply.

In any case, whether you're dealing with a client you know well, or someone entirely new, Customer Due Diligence requires a great deal more than simply asking for a passport or searching for someone on Google.

In this part of the course, we'll explore Customer Due Diligence as it pertains to the BAMF Guidance so that you can be confident that your Customer Due Diligence process aligns with what you're required to do to comply under the 5th Directive for Art Market Participants.

Although we're here to talk about Customer Due Diligence, let's start by clarifying how the regulations define a **customer**, as this will be the person or persons that will be the subject of your Due Diligence.

A customer can be:

- Your **actual** customer - the person/s you are dealing with directly, or,
- Any person claiming to act on **behalf** of your customer, or,
- Any **beneficial owner** of your customer - an individual who ultimately owns or controls (directly or indirectly) the customer.

Consider anyone with whom you intend to enter into a business relationship. This includes looking into a trust or a company to establish who the **ultimate customer** is - aiming to seek out the person behind the company or the trust.

A customer is any party with whom an AMP intends to:

- Establish a business relationship, or
- Carry out an occasional transaction that amounts to a transfer of funds equal to, or in excess of 10,000 euros inclusive of VAT. Expressed another way: the ***total value*** of the invoice.

A business relationship means a business, professional or commercial relationship between an AMP and a customer.

This relationship is one that:

- arises from the business of the AMP, and
- is a relationship the AMP expects, at the time when contact is established, to have an element of duration.

A beneficial owner, in relation to a company (whose securities are not listed on a regulated market), means:

- Any individual who exercises ultimate control over the management of the company.
- Any individual who ultimately owns or controls more than 25% of the shares or voting rights in the company - whether this be directly or indirectly. This includes bearer share holdings or other means.
- An individual who controls the company.

The Customer Due Diligence process undertaken as an Art Market Participant, for any and all transactions with any customer, should see you having established:

- Who you are dealing with and what level of risk the person/s presents.
- With whose art you are dealing.
- The source of the funds, e.g. who is paying for the work?
- The means to effectively identify and monitor high-risk relationships.

When combined, these elements will allow you to establish an appropriate level of risk, which you will often see referred to as '***risk based approach***' in approved literature from BAMF.

Irrespective of the level of Customer Due Diligence undertaken, it might be helpful to think of Customer Due Diligence expressed as a simple formula:

$$\text{ID \& V + KYC = CDD}$$

ID&V, KYC & CDD - The Differences

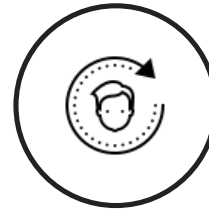
What is the difference between:



Identification
(ID)



Verification
(V)



Know Your Customer
(KYC)



Customer Due Diligence
(CDD)



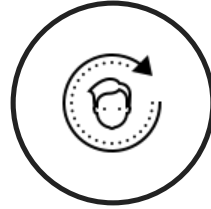
Identification:

Establishing who your customer is.



Verification:

Proving your customer is who they say they are.



Know Your Customer:

Know Your Customer (KYC) is similar to a process of analysis, where subsequent levels of information will be assessed, and the associated risk calculated, in relation to:

Who your client is, where they are and what they do.

The level of risk identified will help you determine the level of Customer Due Diligence you need to undertake: ***Simplified***, ***Standard*** or ***Enhanced*** – as the risk increases, so does the level of due diligence required to address it.

To establish the level of ***'risk'*** the conclusions you reach will be based on the analysis of ***'Positive'*** and ***'Negative'*** information obtained from reliable, independent sources.

Positive Information

'Positive Information' refers to information about your customer from a reliable, independent source.

Reviewing positive information allows you to discover more about your customer. For example, their profession, the sector or the market in which they work.

It is important to be aware of positive information and to factor it into your due diligence reports. In instances when dealing with a customer who is neither a PEP or Sanctioned, positive information helps to fill in the gaps and more conclusively, enables you to assess the level of risk the customer presents.

Let's use an example to explore this:

Imagine you have two customers, one is a surgeon and the other is an investment banker.

With respect to their professions, these two customers do not present the same level of risk. The investment banker presents a higher money-laundering risk due to their relationship - and proximity - to finance.

Positive information could also include the customer's known geographical location, or even something such as a LinkedIn profile or an online article.

We can refer to any and all information outside of ***negative information*** (e.g. PEPs and Sanctions) as ***positive information***.

Negative Information - Sanctions

Negative information sources will tell you if the client you're dealing with is a ***Politically Exposed Person***, or a ***Sanctioned*** individual or entity, or whether the country that the client is located in has sanctions placed against it.

This will also include any adverse media related to them, such as allegations or convictions for criminal activity.

The likelihood of you dealing with a Politically Exposed Person or Sanctioned individual in a given year will be less than 5%.*

*Via the Arcarta Art Market Regulation Report 2020

Sanctions are normally measures used by the international community for one or more of the following:

- To encourage a change in behaviour of a target country or regime.
- To apply pressure on a target country or regime to comply with set objectives.
- As an enforcement tool when international peace and security has been threatened and diplomatic efforts have failed.
- To prevent and suppress the financing of terrorism and terrorist acts.

Most commonly, sanctions are applied:

- To maintain or restore international peace and security.
- To uphold respect for:
 - Human rights
 - Democracy
 - Rule of Law

Who Applies Sanctions?

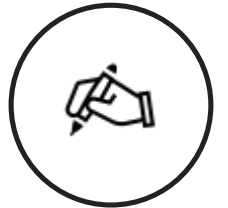
There are many sanctions lists applied by individual countries around the world, if you are doing business in one of these countries you will need to comply.

However, there are **4** main sanctions lists that must ***always*** be complied with.

Activity:

Can you name the 4 main sanctions lists?

The answer will be revealed on the next page.



Here are the 4 main sanctions lists:



The United Nations



The EU



The Office of Foreign
Assets Control (OFAC)
USA



Her Majesty's Treasury
UK

Sanctions can be applied to:



A Country



A Government



A Company/Entity



An Individual

Here are the most frequently used Sanctions:

- Embargoes on exporting or supplying arms and associated technical assistance, training and financing.
- A ban on exporting equipment that might be used for internal repression.
- Financial sanctions on individuals in government, government bodies and associated companies, or terrorist groups and individuals associated with those groups.
- Travel bans on named individuals.
- Bans on imports of raw materials or goods from the sanctions target.

Penalties

Penalties for breaching sanctions orders can be severe, for both art businesses and individuals.

These penalties include:

- Fines
- Deferred Prosecution Agreements/Settlements
- Criminal records
- Ostracization from your peers or industry sector
- Being sanctioned yourself
- Personal accountability – sanctions prosecutions now tend to want those culpable, individually punished.

Duties of art businesses vary according to Sanction regime, but usually mean that a firm must:

- Freeze/block assets/funds.
- Not make assets/funds available to, or deal with assets/funds of targets (directly or indirectly).
- Report the relationship with the sanction party to applicable authority.
- Obtain appropriate licence exempting transaction/activity if available.

Remember!

Compliance with sanctions orders is not optional.

There is no risk-based approach.

Sanctions are comprehensively binding.

US Law and the Office of Foreign Assets Control (OFAC)

OFAC administers and enforces economic and trade sanctions against targeted foreign countries, ships, vessels, criminals and terrorists. This is based on US foreign policy and national security goals/considerations.

Under US law, OFAC has the right to apply US sanctions wherever a US element exists.

Meaning where a US presence exists, then US sanctions must be complied with by that presence.

A US element or presence can be described as:

- All US persons and US entities.
- US-incorporated entities and their branches subsidiaries (wherever they may be located).
- US Citizens and permanent aliens (regardless of where located).
- Those holding dual citizenship with the US (wherever located).
- All US\$ transactions flowing through the US financial system.
- Foreign banks maintaining a correspondent account in the US.
- Use of US software, technology or travel.

The art trade is well known for its high degree of confidentiality and anonymity, along with the subjectivity of value, this makes the art market attractive to criminals keen to manipulate invoice prices to covertly move money around the world.

It is also important to note, that when a sanctioned individual or entity cannot move money due to the application of sanctions, resalable art could become the currency of choice.


Take a look at some enforcement action, fines & settlements issued by the USA:



2018
USD 1.34 bn



2012
USD 619m



2015
USD 1.45 bn




2012
USD 619m



2010
USD 298m




2012
USD 1.9bn



2014
USD 8.8 bn



2012
USD 340m



In 2021 OFAC issued 20 enforcement action notices resulting in fines totaling \$20,896,739.22

Sanctions Mythbusters:

Myth: Sanctions only apply to high value transactions.

Fact: Sanctions apply to all transactions of any value; low-value transactions are not exempt from sanctions.

Myth: Terrorism restrictions only apply to money.

Fact: Terrorism restrictions apply to the provision of both services and funds; they are not restricted to funds.

Sanctions Mythbusters:

Myth - You can 'tip off' a sanctioned individual.

Fact: Sanctions orders are publicly available information so you cannot 'tip off' a subject who is sanctioned. (Side note: 'Tipping off' is not the same as freezing an account.)

Myth: They've been through due diligence before, I don't need to do anything.

Fact: You cannot rely on other firm to have already screened against sanctions lists – an AMP has a responsibility to perform its own checks when dealing with every customer.

Negative Information - Politically Exposed Persons (PEPs)

Despite its title, a PEP is not just someone in the world of politics.

Politically Exposed Person* or *PEP means an individual who is entrusted with prominent public functions (other than as a middle-ranking or more junior official roles). When dealing with a PEP you must also include their family members and known close associates.

A family member of a politically exposed person includes:

- A spouse or civil partner of the PEP.
- Children of the PEP and the spouses or civil partners of the PEP's children.
- Parents of the PEP.

A known close associate of a PEP means:

- An individual known to have joint beneficial ownership of a legal entity or a legal arrangement - or any other close business relations with a PEP.
- An individual who has sole beneficial ownership of a legal entity or a legal arrangement which is known to have been set up for the benefit of a PEP.

Individuals entrusted with prominent public functions include:

- Heads of state, heads of government, ministers and deputy or assistant ministers.
- Members of parliament or of similar legislative bodies.
- Members of the governing bodies of political parties.
- Members of supreme courts, constitutional courts or any judicial body where the decisions that are made are not subject to further appeal except in exceptional circumstances.

This also includes:

- Members of courts of auditors or of the boards of central banks.
- Ambassadors, charges d'affaires and high-ranking officers in the armed forces.
- Members of the administrative, management or supervisory bodies of State-owned enterprises.
- Directors, deputy directors and members of the board or equivalent function of an international organisation.

It is important to remember that not every PEP is a criminal. The title or occupation are the indicator for you that a risk is present, it is not the risk itself.

So what is the risk?

Because of their position in society, a PEP can be exposed to an increased risk of bribery & corruption.

For example, a high court judge may accept a bribe from someone who wishes to influence the outcome of a trial they're presiding over. A councillor or politician may be bribed by a building developer to give planning permission for their works.

Frequently asked question:

In what way would could someone classified as a PEP, buy art and potentially pass corrupt funds onto the gallery?



Answer:

A corrupt PEP could use the proceeds of a bribe to buy some artwork.

By paying for the artwork using the **'dirty'** money from the bribe, they will have converted those dirty funds into art. A week later they could then sell the art and pay the proceeds into their bank account as perfectly clean money.



Another way of thinking about who would classify as a PEP, is whether or not that person has the ability to influence the way that public funds are spent, or decisions made that are (or at least should be) in the public's interest.

In determining PEP status, another consideration is whether or not the person could be bribed, what could they be bribed to do or what could they bribe others to do?

As you can see, CDD plays a huge part in managing PEP risks, and it is not just CDD on the individual themselves that counts here, it is just as important to satisfy yourself as far as you reasonably can, that the money being used to transact is legitimate.

PEP Facts:

- PEPs can be based in the UK or overseas.
- Due to their risk, establishing and maintaining a relationship with a PEP should be approved at the highest level of authority within your business.
- Once a PEP always a PEP – you cannot be ‘de-PEPed’.

The risk of the PEP is one that stays with the individual for life, even after they have left their public office - after all, money obtained via bribery and corruption will always be just that, no matter what job it's beneficiary holds now or in the future.

PEP Facts:

- Once someone has left their public office, you may decrease the level of scrutiny that you apply to them, based on their perceived reduced risk, but they will always be classified as a PEP.
- Family and known close associates are treated in the same way as the PEP.

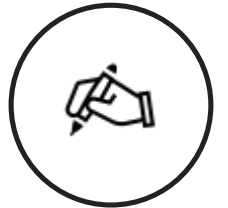
As a PEP, if you knew people were watching your every move, would you try and launder the proceeds of money obtained via bribery and corruption yourself?

Or try to hide and disguise it through someone else's bank and activities?

Activity:

Look at the 6 people on the following page and imagine they all wish to buy a piece of very expensive art.

First of all try and work out who they are.

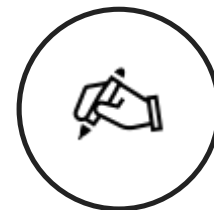




Activity:

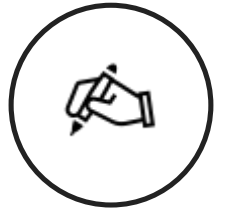
Now answer whether you think they are PEPs or not.

- If you think they are, why?
- If you think they are not, why?
- And if they are not, what risks might they present anyway?



Activity:

Now we'll look at an explanation of each person along with their PEP and risk status.



Christina Kirchner



- Ex President of Argentina.

Yes, a PEP

David Beckham



- Connected to the royal family.
- Attended The Duke & Duchess of Cambridge's wedding.
- Collected the Olympic Flame with Princess Anne.
- He is an OBE .
- President and co-owner of Inter Miami football club.
- UNICEF Goodwill Ambassador.

But does all of this make him a PEP?

Li Ka-Shing



- Entrepreneur.
- 30th richest person in the world (June 2019).
- A Sir.

But does all this make him a PEP?

**He will have lots of contacts and influence –
but a PEP?**

Bill Clinton



- Ex President of the USA and husband of Hillary.

Yes, a PEP

Sheikh Mohammed Bin



- Crown Prince of Abu Dhabi.
- Deputy Supreme Commander of the UAE armed forces.

Yes, a PEP

Angelina Jolie



- Actress.
- Humanitarian.
- A Dame.
- Commander of St Michael and St George.
- A Special Envoy for the United Nations High Commissioner for Refugees.
- Cited as one of the most influential and powerful people in American entertainment history.

In all likelihood, yes, a PEP

So you can see from those examples, that you have to think about all aspects of a person's profile when determining the level of risk that they present to you.

From those 6 examples, 4 were certainly PEPs and so would be classified as **'High Risk'** and need to be subjected to **'Enhanced Due Diligence'** accordingly.

But what about the other two?



Li Ka-Shing



David Beckham

Although the evidence does not suggest that these two are PEPs, it certainly shows that a business relationship with them would carry a greater risk than most other business relationships.

As such they would be classified as **'High Risk'** too, with **'Enhanced Due Diligence'** being required.

So all 6 ended up having **Enhanced Due Diligence** applied, but with very different reasons.

Having this kind of methodology with documented outcomes, enables you to demonstrate, if required, how you reached your decisions and why.

If challenged on these 6 individuals for example, the worst case scenario is that someone has a different view to you and applies a PEP status where you haven't or takes one away where you may have applied it.

The controls for all of them remain the same though: ***High Risk and Enhanced Due Diligence.***

Bribery & Corruption

PEPS are not the only ones who can commit bribery & corruption offences.

The UK Bribery Act 2010 criminalises bribery and also placed a liability on firms that do not take adequate steps to prevent it.

Bribery is any form of given or offered inducement, or acceptance or agreement to accept an inducement.

It is way to obtain or provide a service which is contrary to the service that should be provided.

This is usually to place the person giving or offering to give, at an advantage to others.

This can include, monetary bribes, as well as gifts, entertainment or hospitality – and the bribe doesn't have to be given directly to the person being bribed, or in fact even for their benefit.

Bribery and ***Corruption*** generate the proceeds of crime so are also predicate offences to ***Money Laundering***.

The UK Bribery Act came into force 1st July 2011.

It consolidated existing bribery legislation and created new offences.

These new offenses consist of:

- Two general offences of giving/receiving a bribe.
- One discrete (separate) offence regarding bribing a foreign public official.
- Corporate offence of failing to prevent bribery.
- Liability on directors or the equivalent who consent or connive.

This only requires a UK presence to allow prosecution - which could include up to 10 years in prison and an unlimited fine!

Fraud

Fraud is one of the biggest risks that faces an AMP.

Someone impersonating another in order to buy or sell art work, someone pretending to have the legal right to sell, or providing fake documents to conceal the true identity of the buyer or seller.

This includes providing fake documents or falsifying the provenance of a painting in order to convince you to buy it or sell it on their behalf.

In the UK fraud is criminalised by the **Fraud Act 2006**.

Prior to 2006 fraud was not a separate indictable offence but instead would have been prosecuted under the 1968 Theft Act (obtaining property by deception).

The Fraud Act 2006 defines fraud in these classes:

- Fraud by false representation.
- Fraud by failing to disclose.
- Fraud by abuse of position of trust.
- Possession of articles intended for the use in fraud.
- Making or supplying articles for use in fraud.
- Obtaining services dishonestly.

Fraud generates the proceeds of crime, so is also a predicate offence to Money Laundering.

Prosecution could include up to 10 years in prison and an unlimited fine!

There are three types of fraud:

- Internal
- External
- Collusive

Internal

A person or people inside the company that use their knowledge of the firm's systems and controls to defraud the company and make a personal gain

External

Someone outside of the company that uses deception, impersonation, stolen data or information and confidence trickery, to defraud the company and make a personal gain.

Collusive

An internal and external party that work together, using their knowledge of internal controls and the art of deception to defraud the company and make a joint personal gain.

Often in the case of collusive fraud, the ***internal element*** (the employee) has been groomed by the ***external element*** (the person committing the fraud).

They will use disgruntlement, and lack of pay rise, bonus or promotion as tools to convince the employee to help them.

The Fraud Triangle



When to carry out CDD?

Now let's look at how this begins to fit together:



**Identification
(ID)**

Who your customer is.

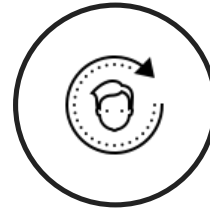
Establishing likeness
using documents
supplied by the
customer.



**Verification
(V)**

Proving their identity

Looking for and
establishing consistency
across the documents
supplied and what you
know to be true about the
customer.



**Know Your Customer
(KYC)**

Using positive and
negative Information to
determine the risk



**Customer Due Diligence
(CDD)**

Establishing a comfort
level and documenting
your reasoning and the
decisions reached
through written reporting
and the storage of reports
of due diligence.

The use of ***Positive*** and ***Negative*** information during Customer Due Diligence is a requirement.

And remember:

Always carry out Customer Due Diligence ***prior*** to entering into a business relationship e.g. ***before*** sending an invoice.

Frequently asked question:

On whom do we carry out Customer Due Diligence?

Answer:

You're required to conduct Customer Due Diligence on anyone you have a business relationship with e.g. Buyers, Vendors, Agents and Employees.



Frequently asked question:

When do we carry out Customer Due Diligence?

Answer:

You will be required to conduct Customer Due Diligence whenever you transact with a customer, where the total value of the invoice (inc. any applicable VAT) **is equal to, or in excess of €10,000.**



Linked Payments

Due Diligence is required for single, one-off payments as well as those payments that are deemed linked. Linked Payments refers to any payments that are linked by both a customer and an invoice.

For example, if a customer pays a deposit then pays the outstanding balance at a future date, or if the customer pays in installments.

The current definition of linked payments from HMRC does not apply to cumulative sales to the same client paying from the same source.

Frequently asked question:

When did CDD come into effect?

Answer:

Customer Due Diligence obligations have been in effect since **January 10th 2020** and you are expected to be able to produce evidence of Customer Due Diligence from that date.



Levels of CDD: Simplified, Standard and Enhanced

Frequently asked question:

How do we determine the level of customer due diligence?

Answer:

By assessing the risk for all new and existing customers. This will be driven by your business' own risk policies.



You will review customers based on the following:

Their customer type - What do they do for a living? How do they generate their money?

Business activities - If they are a business, what is their business line? Who are their customers?

Product or service - What is your customer buying from you or paying you to do? Is it usual to be paid to do this?

Transaction - What is the transaction that is being undertaken? What is its size and value? Is the transaction one you would expect your customer to be undertaking?

Distribution - How do you do business with your customer? Do you ever meet them face to face? Have you ever been to their home or place or work?

Do you only ever deal with them over the internet or phone or via a representative? – the less contact you have with your customer the greater the risk.

Geography - Where is your customer located? If it is a business, where are it's customers located?

Do these countries pose any risk in respect of money laundering or terrorist financing?

Do these countries have high levels of bribery and corruption or domestic or international sanctions against them?

Remember!

A consistent and documented risk assessment methodology and conclusion is essential.

You might have to answer for your decisions one day, possibly even to law enforcement or the Courts.

CDD is conducted at the level and depth required to meet and mitigate the risk of the customer relationship. We refer to this as a '***Risk Based Approach***'.

Simplified Due Diligence:

This is usually applied when your customer is low risk.

This would include when dealing with another regulated entity, or a company that is subject to significant public disclosure and scrutiny – e.g. a company listed on a recognised stock exchange.

Standard Due Diligence:

This is the standard approach for the medium risk, standard, or so called 'vanilla' customer.

Enhanced Due Diligence:

This is for those customers who present a high risk and therefore require you to ask more questions in order to obtain more answers.

Don't forget the 4th classification of risk: unacceptable risk.

There may always be times when no matter how much due diligence is undertaken, the risk presented simply cannot be mitigated or controlled.

These are the times when you must decline the business - because the risk of undertaking it is unacceptable.

A further look into enhanced due diligence

For those customers who present a high risk, ***enhanced due diligence*** must be undertaken.

The ***higher*** the risk, the ***higher*** the level of authority required to authorise the business relationship.

The type and depth of ***enhanced due diligence*** required will vary on a case by case basis.

Broadly speaking, enhanced due diligence could include factors such as:

- Obtaining, and where appropriate verifying, additional information on the customer and updating more regularly the identification of the customer and any beneficial owner.
- Obtaining additional information on the intended nature of the business relationship.
- Obtaining information on the source of funds or source of wealth of the customer.

This may also include:

- Obtaining information on the reasons for the intended or performed transactions.
- Obtaining the approval of senior management to commence or continue the business relationship.
- Conducting enhanced monitoring of the business relationship - this can be done by increasing the number and timing of controls applied and through selecting patterns of transactions that may need further examination.
- Requiring payments to be carried out through an account in the customer's name with a bank that you know will be subject to similar due diligence standards.

As we have mentioned before, due diligence isn't just about identification and verification.

It is also about *knowing* your customer.

Remember:

When what you know about the customer, increases the risk, the customer requires more than standard due diligence.

Summary:

In this section we have taken a more in depth look at ***Due Diligence***, the terms ***ID&V***, ***KYC***, ***CDD*** and the differences between them.

We have covered ***Positive*** and ***Negative Information***, including ***Sanctions*** and completed an activity on ***PEPs***.

The section on ***Fraud*** has helped us to identify when and how this occurs.

And we now have an understanding of ***when*** we should carry out CDD and to ***what level***.

If you are still feeling unsure about any of the subjects we've covered in this section, feel free to return to, and review those areas again.