Citi GPS



GLOBAL ART MARKET DISRUPTION

Pushing the Boundaries

Citi GPS: Global Perspectives & Solutions

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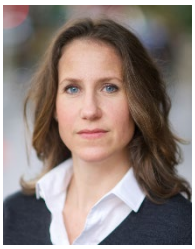

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GLOBAL ART MARKET DISRUPTION

Pushing the Boundaries

Kathleen Boyle, CFA
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The COVID-19 pandemic has been a catalyst for rapid change in the art market. With galleries forced to close their doors, international art fairs postponed, and major auctions delayed, the art world quickly needed to adapt. In our 2020 Citi GPS report *The Global Art Market and COVID-19*, we highlighted how the industry was adept in shifting to the digital world, with leading auction houses conducting virtual auctions, and art fairs going online and creating new kinds of experiences for attendees. Coming from being behind the curve on digital, this belated shift increased transparency in pricing and attracted Millennials who were more comfortable buying art online.

Over one year later, the art industry is continuing to transform and adapt. The shift to digital has given a wider range of people access to the art world than ever before, and increased both the geographic and demographic diversity of buyers. This has led to a stronger focus on diverse artists and genres, and on artists who work outside mainstream platforms. We expect this to continue in 2022, along with new synergies between auction houses, galleries, artists, and collectors, as well as sustained growth in private sales.

The biggest change in 2021 has been the rise of a new art medium — non-fungible tokens, or NFTs. From being nearly non-existent in 2020, this new market generated sales of almost $25 billion in 2021 and posted an additional $7.4 billion in January 2022 alone. NFTs are not only a new way to consume art and collectibles, they are disrupting the traditional art ownership model through a kind of "democratization". This disruption holds the possibility for catalyzing change for both (1) the artists, as it potentially allows them to monetize their work and talent equitably, and (2) traditional distribution players, including auction houses and galleries, who have been quick to be involved in the transformation. Ultimately, the rise of NFTs has helped drive an increase in overall art sales, with $2.3 billion of art sold in just a two-week span at the November 2021 auctions.

The strength of the art market throughout the COVID-19 pandemic is also reflected in the performance of major art indices. From January 2020 through June 2021, the Masterworks.io All Art Index delivered a 28.2% return — comparable to broad, publicly-traded risk asset classes including developed market equities, emerging market equities, and commodities. Broad shifts in real interest rates from negative to deeply negative, helped by stimulus and central bank asset purchases, likely contributed to performance.

Regulation has been and will continue to be a feature of the art market for the foreseeable future. There are still challenges in the NFT market with issues surrounding trademark infringement, security regulations, and the potential for fraud and abuse. And it is not just the digital art market raising concerns among regulators. Lawmakers around the globe have started to implement new laws and regulations requiring certain art market participants to help prevent and detect money laundering in their operations.

With single NFTs regularly selling above the million-dollar threshold, there is also a question about whether the NFT market can sustain current levels. That said, as noted by Anders Petterson, Founder and Managing Director of ArtTactic, "Bursting bubbles rarely signal the end, but rather the beginning of a new development phase."

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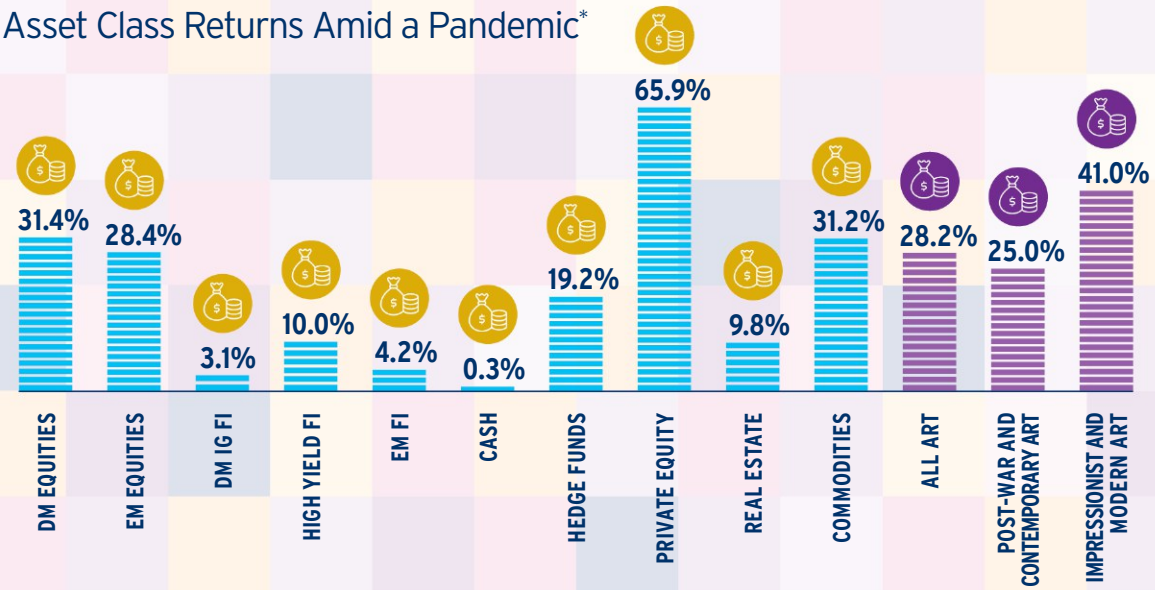
Expanding Boundaries, Expanding Markets

ART CONTINUES STRONG PERFORMANCE

Over an 18-month period during the COVID 19 pandemic from the beginning of 2020 to the middle of 2021 – the global art market as an asset class returned 28.2%, with the Impressionist and Modern Art index gaining 41%. This overall performance is comparable to strong returns from developed market equities, emerging market equities, and commodities.

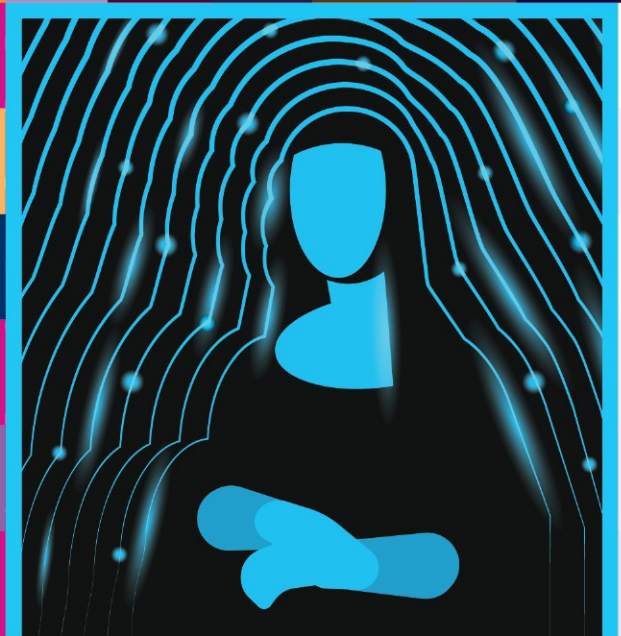
Asset Class Returns Amid a Pandemic*



* Source: Art represented by the Masterworks.io All Art, Post-War & Contemporary Art, and Impressionist & Modern Art indices; All data estimated in U.S. dollars covering period from end-December 2019 to end-June 2021. Other asset class returns estimated by Citi Private Bank's Global Asset Allocation team. Past price performance is no guarantee of future price performance. © 2022 Masterworks.io LLC; All rights reserved. Indices revised as of November 2021. DM = Developed Market; EM = Emerging Market; FI = Fixed Income; IG = Investment Grade

NFTS BOTH A DISRUPTOR AND A CATALYST FOR CHANGE

NFTs, or non fungible tokens, are rapidly gaining mainstream interest across the art market. Spurred by a younger, digitally native audience, the emergence of a new ownership model for digital art has finally become a reality and is disrupting the traditional art market.



NFTs act as a disruptor by creating:

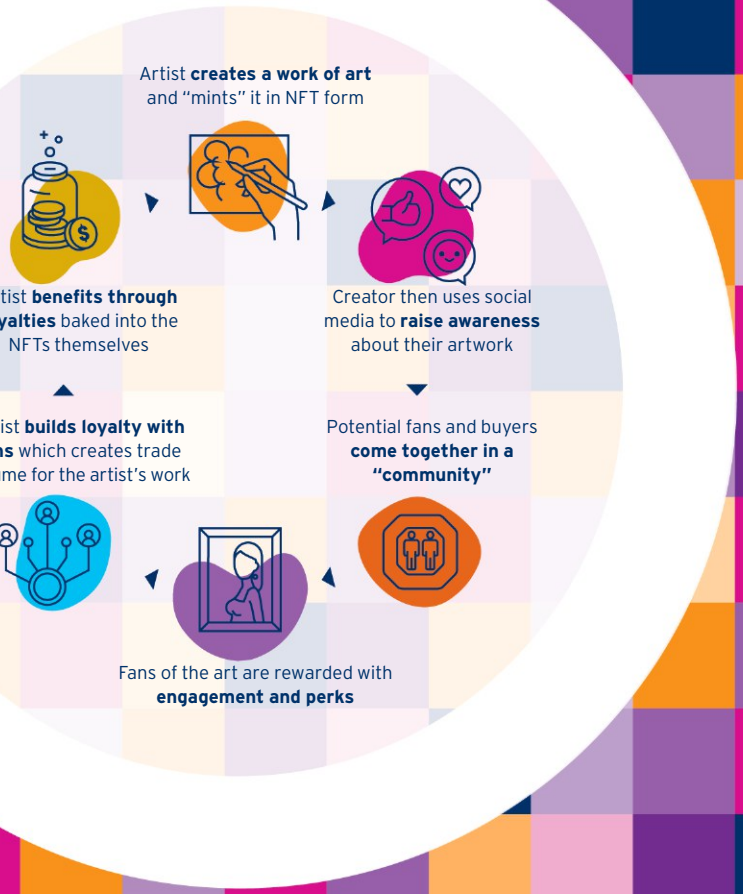
- New ways to consume art and collectibles
- A new ownership model that provides digital scarcity
- A new secondary market that operates without intermediaries

NFTs are also a catalyst for change as they:

- Democratize art ownership
- Help artists monetize their work and talent equitably
- Expand the offering of traditional auction houses, galleries, and art fairs

WHY ARE CREATORS AND CONSUMERS ATTRACTED TO NFTS AS A MEDIUM?

The creation of an art NFT provides a direct relationship between the artist and fans and potential buyers. Raising awareness around an artist s work creates a community with a flywheel effect for all involved – fans get to interact directly with the artist and get access to new artwork, while artists generate royalties from the NFTs themselves.





WHAT WE EXPECT FOR THE ART MARKET IN 2022

Challenges faced by the global art market in 2020 forced the industry to adapt quickly and embrace a more digital world. A wider range of people now have access to the art world than ever before, resulting in trends that became apparent during 2021, and are expected to continue into 2022.

Trends in 2021:

Collector base becoming younger

- Increasing focus on less established and relatively unknown artists
- Galleries and auction houses increasing focus on living artists
- Increased sales in "New Now" portion of Contemporary Art

Collector base becoming more global

- Increased focus on diverse artists
- Increased focus on more "vogue" art vs. "important" or "serious" art

Expectations for 2022:

Continued growth in art market with new participants and new preferences

New synergies between auction houses, galleries, artists, and collectors

Continued strength in private sales

Tightening of regulation as art market expands



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Art in Investment Portfolios: Broad-Based Performance



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Art in Investment Portfolios

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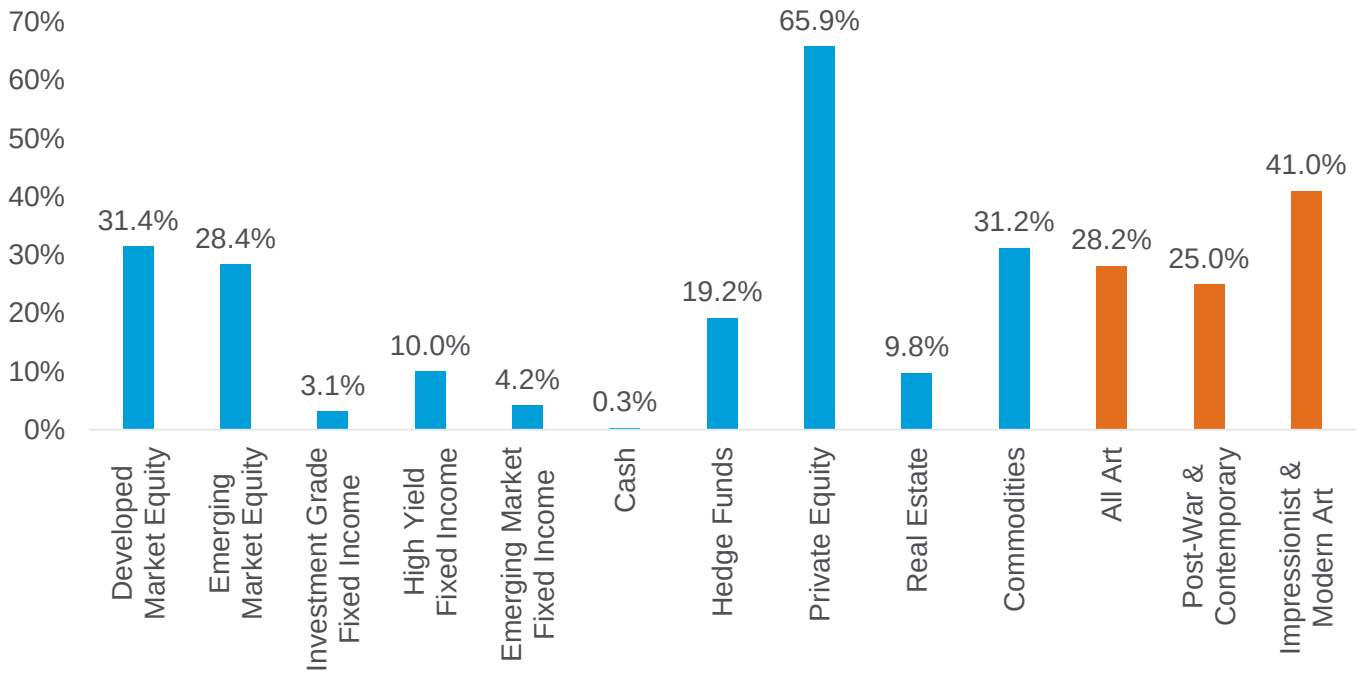
The COVID-19 pandemic has been an unusual period, with persistent health fears and the sharpest global economic downturn in 2020 since the end of World War II, yet also areas of progress and opportunity. The performance of financial markets is a case in point. As of mid-2021, broad asset classes including equities, high-yield bonds and alternatives had surpassed their pre-crisis peaks, in some cases substantially. How did the global art market fared amid these conditions?

To find an answer to this question, we look to the Masterworks.io family of art indices. Masterworks is a platform for buying and selling shares representing an investment in iconic artworks that allows anyone to invest in shares in blue-chip works of art — see www.masterworks.io. Its indices are built from data sourced from auction sales and are calculated using the Case-Shiller Home Price Index methodology. At the end of June 2021 — the latest point for which data is currently available — the Masterworks.io All Art Index was 28.2% above its level at the end of 2019. For the full year 2020, the index was up by 21.2%.

Figure 1. Asset Class Performance Amid COVID-19 (January 2020-June 2021)



Source: Art represented by the Masterworks.io All Art, Postwar and Contemporary Art, and Impressionist & Modern Art price indices; All data estimated in U.S. dollars covering period from end-December 2019 to end-June 2021. Other asset class returns estimated by the Global Asset Allocation team, Citi Private Bank. Past price performance is no guarantee of future price performance. © 2022 Masterworks.io LLC; All rights reserved. Indices revised as of November 2021.

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Art's Recent Performance in Context

The performance of the index in 2020 was strong compared to the index's own history. Since 1962, the Masterworks.io All Art Index has delivered annualized appreciation of 9%. The increase in 2020 also ranks as its highest gain since 2010, when the world was emerging from the Global Financial Crisis. As shown in Figure 1, looking at the 18-month period from the end of 2019 to the middle of 2021, the price performance of art has also been comparable to that of three broad, publicly-traded risk asset classes: developed equities (e.g., shares from advanced economies such as the U.S., U.K., and Japan) which gained 31.5%; emerging equities (e.g., shares from the likes of China, India, and Brazil), which gained 28.4%; and commodities (including metals, energy, and agricultural products), which gained 31.3%.

The strong appreciation rates for the art index in 2020 also seem to have been broad-based. Both the Masterworks.io Post-War and Contemporary Index and the Impressionist and Modern Art Index — which cover the largest categories of the market — registered increases of 19.7% and 19.8%, respectively. Intriguingly, this is lower than the 21.2% price performance for the whole market. Those aggregate increases may have been attributable to other sub-categories such as Asian and Contemporary Art and Latin American Art. Although Masterworks does not publish indices for these specific segments, appreciation of works in these segments in 2020 suggests they were areas of strength.

The performance of art remained robust in the first half of 2021. But while the broad art market grew by 5.8%, the two largest sub-indices diverged after their strikingly similar showing in 2020. While the Post-War and Contemporary Index rose by just 4.4% in the first half of 2021, the Impressionist and Modern Art Index was up 17.8%. The contrast with 2020's similar price performances aside, this divergence marks a departure from the long-term trend across the indices. Since 1985, when the data series began, the Post-War and Contemporary Index has seen stronger appreciation versus the Impressionist and Modern Art Index.

As much as the price performance of art during the pandemic has resembled that of certain other risk asset classes, there is also at least one difference. Although the likes of equities, high-yield fixed income, and real estate saw sharp declines in value in early 2020, no such effect is apparent for art. Whereas price data for other asset classes appear in real time or at least monthly, the Masterworks indices are published semi-annually. There is no sign of a sell-off in the broad market's performance for the first seven months of 2020. The All Art Index registered a 5.5% increase for that period.

Around various previous episodes of widespread turmoil, art prices have frequently suffered alongside other risk asset classes, such as high yield bonds, commodities, and equities. During the Global Financial Crisis in 2008-09, the Masterworks.io All Art Index dropped 25%, while it dropped 56.2% in the early 1990s recession. Substantial and more frequent drawdowns were also seen during the inflation-ravaged 1970s, although art still produced positive real returns during the period of highest inflation.

In 2020, the general turmoil was brief, albeit intense, with U.S. large-capitalization equities — represented by the S&P 500 Index — declining 34% in just 33 days. At that time, art auctions and other sale activity were largely suspended owing to COVID-19 restrictions, such that little price data exists. Rather than showing art's resilience, therefore, the lack of a substantial art market sell-off in early 2020 reflects the market's effective closure for business at that time.

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Perhaps the closest precedent for this was October 1987, where equities experienced a dramatic but short-lived crash. Annual art returns for the years 1987 and 1988, however, were very strong.

Explaining Art's Recent Strength

While art may not have sold off in early 2020, it participated fully in the rally in risk asset classes from late March onwards. Stimulus was the main driver of the powerful surge in risk asset classes. The rapid and unprecedented monetary intervention by leading central banks not only prevented financial markets from seizing up but buoyed them. On the fiscal side, emergency spending measures by many governments also helped to cushion the blow of forced economic shutdowns.

Enormous asset purchases in 2020 and 2021 by global central banks have helped to keep bond yields near multi-year lows. At the same time, the economic reopening in 2021 brought a noticeable rise in inflation across many countries. In the U.S., for example, the year-over-year rate of inflation reached 7.5% in February — the highest rate in forty years. As a result of economic expansion and inflation, real interest rates — i.e., rates adjusted for inflation — went from somewhat negative to very negative (see Figure 2). This too represented a multi-decade low.

Figure 2. Real Rates: From Negative to Deeply Negative



Source: Bloomberg, as of January 30, 2022. Past performance is no guarantee of future returns.

Over time, art prices have tended to have an inverse relationship with broad shifts in real interest rates (see Figure 3). When real rates have fallen, the art market has tended to rise. This phenomenon relates to art's characteristics as a non-yielding asset class. Art pays no income stream to its owners, in contrast to bonds that pay coupons and some equities that pay dividends. Indeed, art has a negative income stream, given that its owners have to pay out ongoing costs such as insurance, storage, shipping, and maintenance.

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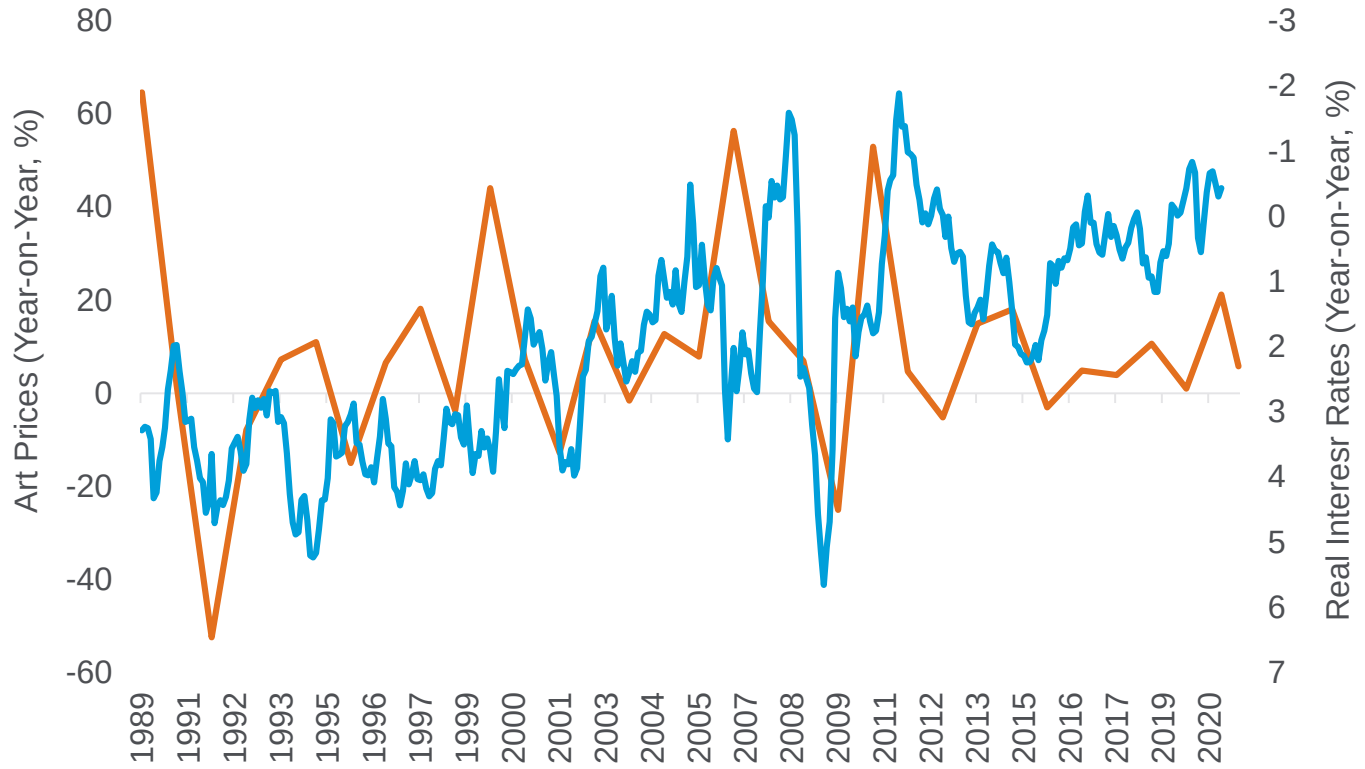
Figure 3. Lower Real Rates, Higher Art Prices



Source: Bloomberg, as of January 1, 2022. Past performance is no guarantee of future returns.

If real interest rates rise, art also has an opportunity cost. Its owners forego potential returns they might otherwise have made had they invested instead in interest-bearing assets. In an environment such as today's, with real interest rates negative, this opportunity cost is not an issue. The same consideration applies to gold, another tangible asset. In the low to negative real rate environment of recent years, both art and gold have registered gains, albeit not at the same time. While gold performed more robustly from 2016 to 2019 — perhaps correcting a pronounced pullback between 2011 and 2015 — art has led the way from 2020 onwards.

The Outlook for Art

Citi Private Bank's proprietary strategic asset allocation methodology does not address art. We instead approach art primarily from the collector perspective of the clients whom we serve rather than strictly as an investment. In any case, art does not lend itself to an objective cash flow-based analysis as equities, fixed income, and real estate do. In this regard, it has more in common with commodities. As such, rigorous estimates of future long-term returns are not possible.

The outlook for real interest rates may be a key influence on art returns, with the persistence of negative real rates over the coming decade very possible. We liken the effect of negative real interest rates on cash and many bonds to activities of a "cash thief," who stealthily pilfers investors' purchasing power.[1] In 2021, the cash thief was prolific, plundering trillions of dollars in this way globally. Given the inverse relationship between art performance and real interest rates, in such an environment, the art market may be able to register further positive real returns.

[1] Steven Wieting, "Beat the Cash Thief!" Citi Private Bank, December 9, 2021.

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The extension of other recent trends may also assist the art market. Interest in collecting art has broadened alongside increasing levels of wealth worldwide but particularly in faster-grower emerging economies in Asia. Simultaneously, access to the art market has become easier, thanks especially to the advance of digital technology. Further innovation could attract yet more people to collect art, particularly among the younger generations of wealth owners.

Risks to Art

While our base case is for conditions that have historically favored the art market, there are risks to our view. Given history, a significant rise in real interest rates would threaten the art market. One possible scenario might involve inflation increasing even further and remaining at high levels, requiring central banks to raise policy rates aggressively. Such moves to choke off inflation in the 1970s and early 1980s were followed by substantial declines in the art market.

In recent decades, the art market has also benefited from growth in the world's ultra-wealthy population. A larger number of multi-millionaires and billionaires represent greater potential demand for expensive works of art. Some of the most significant increases have occurred in emerging economies, particularly those in Asia. Any reversal of this trend — perhaps resulting from declines in investment portfolio wealth — would likely be detrimental to art.

Art in Portfolios

Interest in art — both for collecting and investment purposes — may well continue to grow over the coming years. Market accessibility is continually improving thanks to innovative technology.

Appreciating and purchasing artworks digitally took a great leap forward during the lockdowns of 2020, and these practices look set to endure and evolve. From an investment perspective, new methods of art ownership that enable fractional ownership of fine artworks open the market to even more potential buyers, well beyond the ultra-wealthy cohort.

Besides the quest for returns in a negative real interest rate environment, diversification will remain an important consideration. Over the long term, art returns have had a low correlation with all the broad asset classes that our strategic asset allocation methodology addresses. Most of its correlations were weakly positive or close to zero (see Figure 4). Its strongest relationship was with real estate — another tangible asset class — with a correlation of 0.21. In fact, art's correlation characteristics are quite rare as far as asset classes go. Typically, one asset class (e.g., developed market equities) might have a lower correlation to another asset class (e.g., developed investment grade fixed income) but might simultaneously have a higher correlation to a third asset class (e.g. emerging market equities).

Broad-based exposure to the art market or to a category within the market thus may help mitigate overall portfolio risks while also pursuing positive real returns. There is more to art than meets the eye.

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Figure 4. Art's Correlation with Other Asset Classes

1962 2020	Dev. Market Equities	Emg. Market Equities	Invest Grade Fixed Income	High Yield Fixed Income	Emg. Market Fixed Income	Cash	Hedge Funds	Private Equity	Real Estate	Commodities	All Art	Post War & Contemporary Art	Impressionist & Modern Art
Developed Equities	1.00	0.64	0.25	0.63	0.31	0.04	0.77	0.79	0.52	0.11	0.09	-0.04	0.11
Emerging Market Equities	0.64	1.00	-0.07	0.54	0.52	-0.02	0.56	0.53	0.37	0.44	0.20	0.18	0.28
Investment Grade Fixed Income	0.25	-0.07	1.00	0.45	0.11	0.31	0.45	0.08	0.12	-0.26	-0.08	-0.33	-0.18
High Yield Fixed Income	0.63	0.54	0.45	1.00	0.41	-0.05	0.65	0.51	0.29	0.11	-0.07	-0.38	-0.17
Emerging Fixed Income	0.31	0.52	0.11	0.41	1.00	-0.09	0.39	0.34	0.29	0.50	0.01	-0.02	-0.02
Cash	0.04	-0.02	0.31	-0.05	-0.09	1.00	0.46	0.03	-0.01	0.00	0.12	0.31	0.29
Hedge Funds	0.77	0.56	0.45	0.65	0.39	0.46	1.00	0.73	0.46	0.12	0.11	-0.11	0.09
Private Equity	0.79	0.58	0.08	0.51	0.34	0.03	0.73	1.00	0.73	0.04	0.07	-0.16	0.06
Real Estate	0.52	0.37	0.12	0.29	0.29	-0.01	0.46	0.73	1.00	-0.01	0.21	-0.08	0.21
Commodities	0.11	0.44	-0.26	0.11	0.50	0.00	0.12	0.04	-0.01	1.00	0.19	0.22	0.23
Art	0.09	0.20	-0.08	-0.07	0.01	0.12	0.11	0.07	0.21	0.19	1.00	0.77	0.92
Post-War & Contemporary Art	-0.04	0.27	0.15	-0.18	0.10	0.29	0.15	0.10	0.15	0.18	0.77	1.00	0.55
Impressionist & Modern Art	0.11	0.28	-0.18	-0.17	-0.02	0.27	0.09	0.06	-0.04	0.23	0.92	0.57	1.00

Source: Citi Private Bank Global Asset Allocation Team, as of January 1, 2022. Correlations are measured on a scale of 1 to -1, where 1 = two asset classes move in the same direction all the time; -1 = two asset classes move in the opposite direction to each other all the time. Art represented by the Masterworks.io All Art, Contemporary Art and Impressionist Art Indices © 2022 Masterworks.io LLC; All rights reserved. Indices revised as of November 2021.

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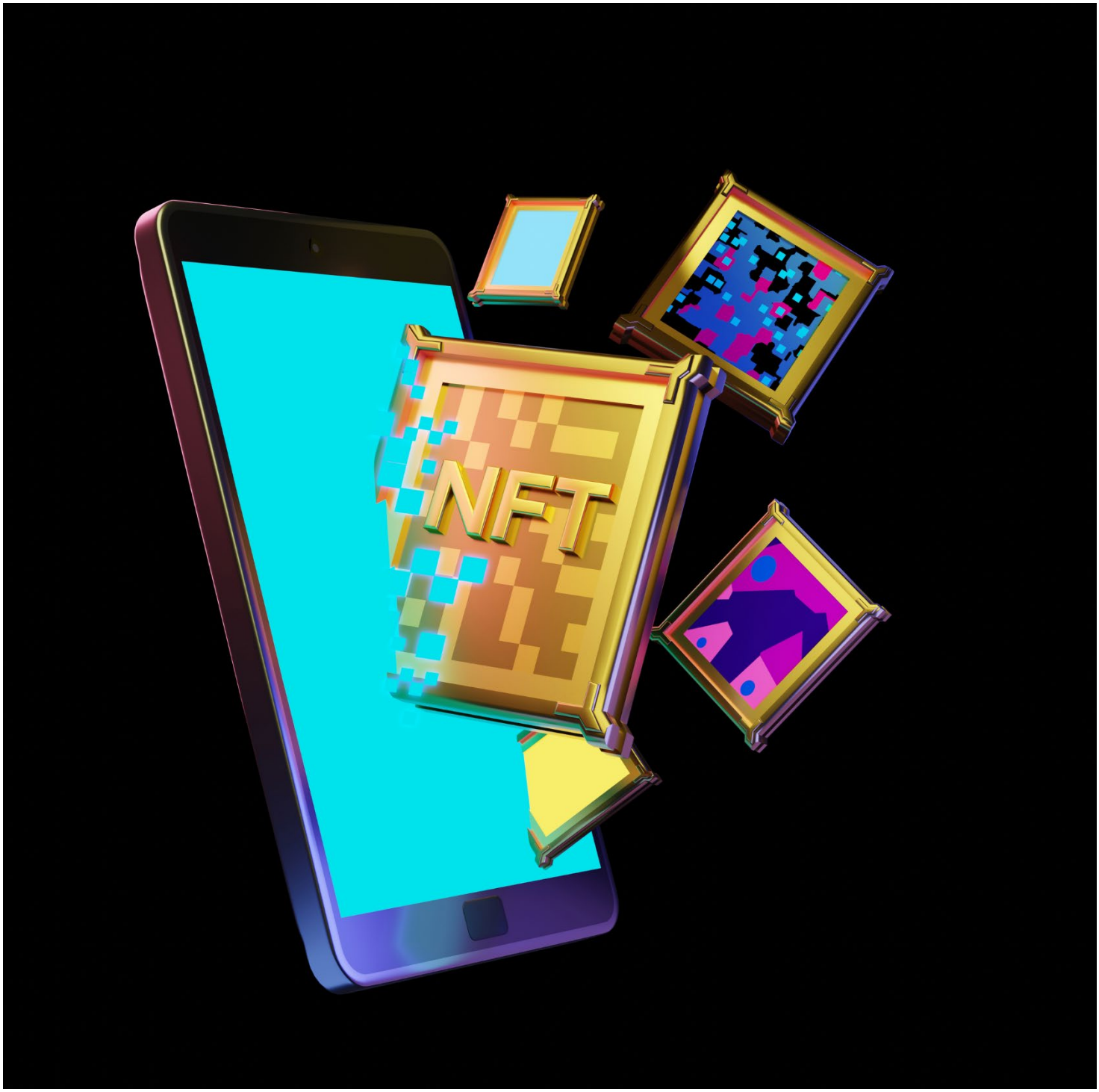
NFTs:
Disruptor, Catalyst, or Bubble



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NFTs — Disruptors, Catalyst, or Bubble?

Anders Petterson
Founder and Managing Director, ArtTactic

As the global art market bounced back in 2021 from the lows of the COVID-19 pandemic, another lockdown phenomenon has dominated the media headlines over the last few months, namely non-fungible tokens, or NFTs. NFTs are rapidly gaining mainstream interest as global brands from Walt Disney to Nike launch their own NFTs. Unsurprisingly, the art market is also taking notice, with Sotheby's and Christie's spearheading the art market's entry into NFTs and the metaverse.[2]

Although NFTs can be traced back to 2014, the market for NFTs really started to accelerate in December 2020 when the digital artist, Beeple, set a new record for *The Complete MF Collection*, which sold for more than $3.5 million through Nifty Gateway, one of the world's largest curated NFT marketplaces.[3] Three months later, Beeple's *Everydays: The First 5000 Days* sold for a record $69 million at Christie's — an event that opened up the flood gates for the NFT market, and which, according to a recent article in Reuters and based on data from DappRadar, reached sales of $24.9 billion in 2021, compared to just $94.9 million the year before.[4]

So, what are the implications for the traditional art market? In the following sections, we take a closer look at how the art market has responded to date and what might be in store for the future.

Disruptive Model

What the art world has lacked for a long time is a new way of consuming art and collectibles. NFTs are providing a potential new model for this to happen. Spurred by a younger, digitally-native audience, the emergence of a new ownership model for digital art has finally become a reality.

Up until very recently, the world of art buying and selling has been something that has generally happened in physical spaces with physical artworks; however, as we have seen over the last two years, the online art market has rapidly changed this. But while buying and selling physical artwork over the internet has grown exponentially, collecting digital art has remained a niche market with only a small number of dedicated collectors.

[2] The metaverse is a virtual world in which participants, represented by an avatar, can network, buy, sell, play, invest, and learn. Its development has become a priority for many tech companies, including Facebook (which recently changed its company name to Meta) and Microsoft. Sotheby's launched its presence in the metaverse in June 2021, when a digital replica of their London Galleries was launched on Decentraland.
[3] The digital artist, Kevin McCoy, minted his non-fungible token "Quantum" on May 3, 2014.
[4] Elizabeth Howcroft, "NFT Sales Hit $25 Billion in 2021, But Growth Shows Signs of Slowing," Reuters, January 11, 2022.

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So how does the advent of NFTs change this? In simple terms, an NFT stands for "non-fungible token," and can be described as a unique asset in the digital world that can be bought and sold like any other piece of property or asset, but which has no tangible form of its own. NFTs seek to achieve something unique — creating digital scarcity. From a buyer's perspective, the NFT market has in certain ways "democratized" the ownership of digital art by building an infrastructure that creates unique, traceable, and undisputed ownership records of a digital artwork. This record can be easily traded in the secondary market and functions without the need for any traditional art market intermediaries. Therein lies the potential for disruption.

Another powerful aspect of an NFT is that it allows digital artists to monetize their work and talent in a potentially more equitable manner, and can redefine the relationship they have with the market and audiences. While the first wave of NFTs have largely been from digital artists operating outside the traditional art market, we are likely to see more adoption of NFTs from the art world in coming years, with both artists and intermediaries carving out their role in this new virtual and digital ecosystem.

What role should the traditional art market play in the future development of the NFT market? Sotheby's, Christie's, and Phillips quickly understood the value of embracing NFTs both from a branding perspective and as an effective tool to engage and cultivate a new generation of crypto-millionaires. The auction houses have carved out their position as the bridge between the old and the new art value system, adding their own "brand premium" and validation to the nascent NFT market.

This might be a path to follow for other art market stakeholders. One of the aspects rarely discussed in the NFT art market is the question of "quality." Who decides? What are the benchmarks? There are ample opportunities for existing art market players to create and influence the development of the NFT art market going forward, by building on their reputation, expertise, and knowledge, and to help build a validation and reputation system that merges the old with the new.

It is time for the art world to get off the fence, and explore what this new technology can potentially offer. And while the frenzy and speculation in the NFT market might go away, the technology itself will not.

Catalyst for Change

In recent months, NFTs have opened up and created possibilities of new models of collecting both digital and physical art, and in the process have arguably added new value to both the collecting experience and artworks themselves.

International auction houses have been at the forefront of bridging the traditional art market with the emerging market for NFTs. It was Christie's and its sale of Beeple's *Everydays: The First 5000 Days* in March 2021 for a record $69 million that opened up the flood gates for the NFT market, and it was Sotheby's record sale of a single *CryptoPunk #7523* in June 2021 for $11.8 million that spearheaded the CryptoPunk boom that followed, generating sales of an estimated $1.05 billion between July and October 2021. There is no doubt that the crypto community is using the good old-fashioned bricks-and-mortar reputation of the auction houses to validate these new forms of digital collectibles. At the same time, the auction houses seem happy to take their share of the crypto boom, and build closer relationships with crypto collectors and investors.

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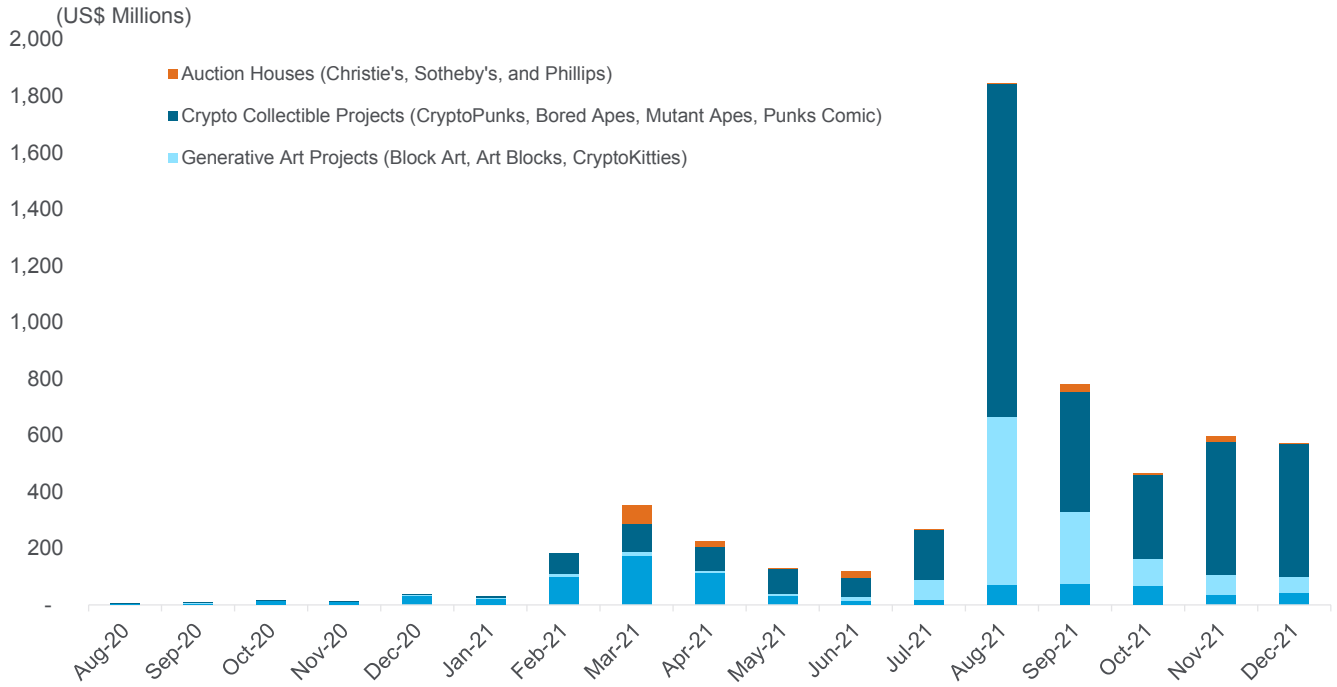
Besides the auction houses' foray into NFTs in the spring of 2021, we have also seen blue-chip galleries such as Pace Gallery announce a dedicated NFT platform in 2021, with two major NFT projects launching in collaboration with artists Simon Denny and Urs Fischer. Another gallery, Unit London, launched Institut, an art world-led platform for NFTs in July 2021.

Some big-name artists are also embracing NFTs. In August, Damien Hirst launched his first NFT project called *The Currency*, a collection of 10,000 NFTs, which correspond to 10,000 unique physical artworks by the artist. By early November 2021, more than $70 million worth of Hirst's NFTs had been transacted.

For many galleries, launching NFTs on OpenSea, SuperRare, Foundation, Nifty Gateway, or any of the other NFT marketplaces would be quite a big leap, as many galleries are still adjusting to selling traditional art online. However, as more familiar online platforms start embracing NFTs, traditional galleries might find it easier to take the next step into the world of NFT-ization. According to recent findings from the *Hiscox Online Art Trade Report 2021*, existing online art platforms are already moving into the NFT space. More than half of online art platforms surveyed in the report were offering NFTs or will do so in the near future. The adoption of NFTs into existing product offerings is already underway. Among online art platforms surveyed, 14% said they are already offering NFTs through their platform, with another 38% planning to do so in the near future. In August 2021, two online platforms, Artnet and 1stDibs, both announced the launch of their proprietary NFT platforms. Even the art fairs are getting in on the game, with Art Basel Miami launching its own NFT exhibition in collaboration with the blockchain currency Tezos in December 2021.

Figure 5. NFT Art and Collectible Market: Selected Curated NFT Platforms and NFT Collectible Projects



Methodology: Data sources are collected from ArtTactic, NonFungible.com, and CryptoSlam!. NFT sales in this analysis are based on some of the key curated NFT platforms such as SuperRare, Rarible, Nifty Gateway, MakersPlace, KnownOrigin, Foundation, BlockArt, Async Art, as well as NFT sales through Christie's, Sotheby's, and Phillips. Crypto collectibles are based on data sales from CryptoPunks, Bored Ape Yacht Club and PUNKS Comic. Generative art is based on sales of CryptoKitties, ArtBlocks, and BlockArt.
Source: ArtTactic

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While the first NFT boom (which peaked in March 2021) was largely focused on digital art by single artists, the recent boom in crypto collectibles, such as CryptoPunks and Bored Ape Yacht Club (BAYC), suggests that collecting habits are moving towards a different NFT collectibles market focused on code-generated art (algorithmic art) aimed at generating communities of followers, buyers, and investors. Although the art itself might be perceived as trivial for outsiders, the combination of uniqueness, ownership, community, gamification, and storytelling is fueling sales of this type of digital collectible among a new generation of buyers and investors.

Virtual worlds or metaverses are also likely to play an important role in the near future, as the next evolution of connectivity. These virtual worlds will allow users to act and interact — combining virtual reality, augmented reality, online gaming, social media, NFTs, and cryptocurrencies. The development of the metaverse has become a priority for many tech companies, including Facebook (which recently changed its company name to Meta) and Microsoft. In the art market, Sotheby's has already established itself in one of these metaverses, by creating a digital replica of its New Bond Street galleries in the Voltaire Art District of Decentraland. In June 2021, the auction house launched the "Natively Digital" curated NFT sale, which was streamed live into the virtual gallery, and resulted in a new record for a single CryptoPunk, when #7523 sold for $11.8 million.

Bursting Bubble

With single NFTs regularly selling above the million-dollar threshold, and an estimated $3.5 billion worth of NFT art and collectibles transacted in the first nine months of 2021, there are frequent questions what the fundamental value of these digital assets are, and whether the NFT market can sustain current levels.[5]

It might be useful to draw a comparison between the boom and bust of the Initial Coin Offering (ICO) market that took place between 2016 and 2019 and the current rise in the NFT market. Is there a risk the same destiny could face the NFT market? And what lessons can be learned?

Among the first notable ICO was Ethereum in 2014. The organizers sought to finance the development of a new blockchain, different from that of Bitcoin, implementing the famous "smart contracts" that now govern most of the NFT market. During 2017, ICOs became a way for start-ups and online projects to raise money without selling stock or going to venture capitalists — it was essentially a new form of crowdfunding and an analogy for classic initial public offerings (IPOs).

ICOs were the antithesis to the Silicon Valley venture capital industry. The market was seen by some as a way to rebel against existing authority and traditional capitalism, and some entrepreneurs and investors were starting to dream about a new, decentralized future offering an alternative to existing rules and practices. The ICO market quickly caught on given the prior perceived successes of Bitcoin and Ethereum, and between 2017 and 2019, an estimated $19.2 billion had been raised from ICOs.[6] However, the market started to wobble in 2018, and out of the 141 largest ICOs in 2017, 86% were trading below their listing price by October 2018, and 30% had lost almost all their value according to an EY study at the time.[7]

[5] Hiscox, *Hiscox Online Art Trade Report 2021,* October 2021.

[6] "Total Funding Raised by Blockchain Initial Coin Offerings (ICO) Worldwide in 2017 and 2019 Link)," Statista, accessed February 22, 2022.

[7] EY, *Initial Coin Offerings (ICOs): The Class of 2017 – One Year Later,* October 2018.

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An academic study found that for ICOs issued in 2019, 87% of these tokens were trading below their ICO price by July 2020 and only 13% were profitable, with more than 65% of tokens having lost most of their value.[8]

What caused the collapse of the market? Lack of regulation was one factor, and the significant number of scams, fraud, and cases of manipulation clearly dented confidence in the market. A study published in 2018, claimed that 81% of ICOs were scams and only around 8% of ICOs went on to the trade on the designated cryptocurrency exchanges.[9] The question about regulation in the crypto currency market is still a hot topic and in August 2021, U.S. Securities and Exchange (SEC) Chairman Gary Gensler called cryptocurrency an asset class "rife with fraud, scams, and abuse" and said investors do not have enough regulatory protection from the swarms jumping into crypto finance, issuance, trading, and lending. This was a clear signal towards a strategy to regulate the crypto market, but so far, the growth and innovation of cryptocurrency markets have outpaced the government's ability to create and impose a suitable regulatory framework for this new asset class.

Despite the ICO bubble that burst in 2019, the ICO model nevertheless gave birth to many of the important building blocks in the current blockchain and NFT ecosystem — from Ethereum to Decentraland. The market frenzy seen in the NFT market in 2021 bears many of the hallmarks of previous crypto booms — large volumes of new entrants, FOMO (fear of missing out), prices shooting up exponentially, "pump-and-dump" strategies, high levels of volatility, and low liquidity. Like the previous ICO boom, the majority of NFTs might end up worthless or illiquid. However, the art world has been generally cautious in embracing NFTs over the last 18 months, and there is limited risks of spillovers to the traditional art market in case of a collapsing market. Also, bursting bubbles sometimes signal not the end, but rather the beginning of a new development phase often built on the winners from the previous cycle – a path NFTs might follow.

[8] Lars Haffke and Mathias Fromberger, *ICO Market Report 2019/2020 – Performance Analysis of 2019's Initial Coin Offerings*, December 30, 2020.
[9] Shobhit Seth, "80% of ICOs are Scams: Report," Investopedia, April 2, 2018.

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NFTs: Beyond Art



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NFTs — Beyond Art

Digital Assets Group
Citi Global Wealth

Before 2020, many millennials had never purchased physical art. Yet nowadays, many are finding themselves perusing digital galleries full of artworks to decorate the walls of their own digital galleries, which are created by organizations such as RTFKT (pronounced “artefact”). The pieces on the wall and the gallery itself are issued as non-fungible tokens (NFTs), where anybody can walk around the gallery on their web browser or via virtual reality headset, and even make offers on a piece they might want to purchase.

In January 2022, roughly $7.39 billion worth NFTs traded hands, according to The Block Research.[10] This was by far a single month record, and comes amidst a broader equity and crypto market selloffs.

The “metaverse” is here and is not some distant dream.

Figure 6. A Digital Gallery



Source: oncyber.io

With growing volumes and a broadening audience, the NFT landscape is evolving rapidly. What started as simple “profile pictures” of animated characters to use on social media platforms is now attracting traditional artists, musicians, and entrepreneurs seeking to utilize the technology and enable digital ownership and scarcity such as private dining club membership tokens.[11]

So besides “liking the art,” why are creators and consumers alike attracted to this new medium? Some will say it is due to pure speculation and profit seeking, which is certainly a component. But this overlooks the potential benefits of fundraising and community-building for creators. After the creation of an artwork and “minting” the pieces in NFT form, creators typically use social platforms like Twitter, Instagram, Telegram, and Discord to raise awareness about their artwork, often bringing in thousands of potential fans and buyers to interact with the artist directly. For example, three of the pieces in the pictured gallery in Figure 6 above are works from Refik Anadol, a pioneer in “AI data paintings.”

[10] “NFT Marketplace Monthly Volume Link),” The Block, accessed February 17, 2022. [11] “The 1st NFT Restaurant Link),” VCR Group, accessed February 17, 2022.

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In collaboration with Google Quantum, Refik issued 1,000 computer-generated "synthetic landscapes" and built a Discord community of now ~7,000 fans and collectors where Refik himself is often hosting Zoom meetings to interact directly with his community, and offering access to real-world exhibits of his artworks at places such as ARTECHOUSE in New York City.[12] Another example is artist Kurtis Dawe taking his experience working on household name movies from Disney and Marvel to the NFT art world with his release of Prime Ape Planet, whose Discord community amassed over 400,000 fans.

This building of communities can create a flywheel effect for all involved. Fans of the art and artist are rewarded with engagement and perks, which build loyalty and awareness for the artist's next work, which in turn builds trade volume of the works, which benefits the artist through royalties baked into NFTs themselves. Royalties on NFT sales typically range from 2.5% to 10%, which on $7 billion plus of volume in January alone is certainly attractive for artists old and new.

The fundraising mechanism of NFT issuance and royalties also allows issuers to further develop the utility of the NFTs they issued. Looking at the well-known NFT project Bored Ape Yacht Club, the project's founders issued 10,000 NFTs which now trade at a floor price of 99 Ethereum (ETH) each (equivalent to $315,000 as of February 7, 2022) and over $1 billion equivalent has traded with a 2.5% royalty to founders. This money has been used to grow staff and partner with gaming producers to create mobile games, one of which was released in early February 2022 and attracted thousands of users competing for real-world prizes. In this example, the NFT is simply an image of an ape, but it also acts as a membership token to an exclusive community amongst crypto-natives and celebrities alike.[13] Universal Music Group has even formed a virtual band called "Kingship" made up of Bored Apes that will produce music and perform in the metaverse. The direct-to-consumer model of NFT issuance can be potentially compelling for artists and musicians alike, and companies are beginning to jump on board to both protect their own intellectual property and capitalize on new consumer engagement models that could bring significant new revenue streams, even if cannibalizing existing sources of income.

In addition to art and music, NFTs are creeping into the esports/gaming world, where gamers spend over $50 billion on in-game items annually already.[14] Where gamers would purchase outfits or "skins," or unique assets or abilities that help level up their characters, the money spent goes straight to the game creator, the asset itself is still owned by the game, and can only be used within that game. Now, with NFT-based gaming, players can truly own similar in-game skins or assets, with the company still benefiting from issuance cost and ongoing royalties of players trading items. Additionally, game creators have incentives to allow items to be interoperable with varying games, increasing royalties and gamer loyalty. We have already witnessed the rise of blockchain-based games by blockchain-natives, such as Axie Infinity, The Sandbox, Vulcan Forged, Decentraland, and Gala Games, and we are likely to see traditional gaming studios looking at both offensive and defensive ways to engage with the technology going forward.

[12] "Machine Hallucination: NYC Link)," ARTECHOUSE, accessed February 17, 2022.

[13] Andrew Hayward, "The Biggest Celebrity NFT Owners in the Bored Ape Yacht Club," Decrypt, January 31, 2022.

[14] "Consumer Spending on In-Game Purchases Worldwide from 2020 to 2025 Link)," Statista, accessed February 22, 2022.

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Lastly, the long-heralded tokenization of real estate may be finally arriving. One pioneer in the space, Propy, told the news outlet Blockworks they "have developed all the necessary smart contracts and a compatible legal framework that allows tokenizing any real estate property in the United States."[15] Not only do they have the legal framework in place, their latest Florida home hit the market with a $650,000 starting point, where the home's deed and all property rights will be minted as an NFT. So far, 1,500 bidders have registered for the auction. Reduction of closing time and costs are the goals here, and a key area to watch develop outside the art and media space for NFT disruption.

Not All Fun and Games

While unique digital property and provenance have already created a significant industry and offer potential disruption across numerous others, the market is still in its infancy and open to nefarious actors or opaque legal frameworks, in addition to investment risks such as price volatility and illiquidity. For example, fashion company Hermès is suing an NFT artist for creating the *MetaBirkins*, accusing the artist of leveraging the famous "in real life" Birkin Bag the company sells for $10,000 to $500,000 per piece. The company claims trademark infringement, while the artist claims free speech. The ongoing case is likely to have ramifications on other artists' works across the industry, but regardless of the outcome, it may shed light on the court's views on artistic freedoms in the digital realm.

Figure 7. Examples of Mason Rothschild's *MetaBirkins*



Source: Artnet

Furthermore, regulators are also forced to consider whether or not many of these NFTs are in fact securities. If you raise money by issuing tokens, use that money to build a network and products such as games, and profit off what is built using money from the issuance, then there is potential for securities law violations in the eyes of regulators as the issued tokens are unregistered and available to the public. Many market participants are calling for more specific clarity from securities regulators on the right approach to issuance without hindering innovation. U.S. Securities and Exchange (SEC) commissioner Hester Peirce spoke at Draper Goren Holm's Security Token Summit in March 2021 stating, "People are being very

[15] Morgan Chittum, "NFT Home Sale Has 1,500 Bidders Lining Up," Blockworks, February 7, 2022.

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creative in the types of NFTs they're putting out there. You better be careful that you're not creating something that's an investment product, that's a security."[16] Further, the NFT community calls for guidance have been heard, but the challenge for regulators is balancing a pro-innovation and pro-safety approach for an emerging market that anybody with an internet connection can tap into.

As with many new internet-based technologies and applications, there is potential for fraud and abuse. As blockchain-based applications are typically permissionless, meaning anybody in the world with a smartphone or computer can access them and issue assets in token or NFT form, there are avenues for bad actors to take advantage of those without expertise in the field. The term "rug pull" has become all-too common in the industry, describing a fraudulent project in which an NFT issuer promises an attractive roadmap of the utility for an NFT, issues the tokens to raise capital, then disappears altogether. Citi Ventures-backed blockchain analytics firm TRM Labs showcases two examples of rug pulls here (Link), such as the "Baller Ape Club" project whose founders raised $2 million from investors then subsequently deleted both their websites and Discord community chatrooms, and disappeared with the money. Firms like TRM Labs and Chainalysis are service providers working with law enforcement globally to help trace illicit on-chain activity. However, it is still important for those involved with blockchain-based assets to truly do their own research and know what they are buying.

While rug pulls have been relatively small compared to the total volume of NFTs trading daily, there has also been a rise in wash trading and potential money laundering on certain platforms. Wash trading is where a single party is both the buyer and the seller of an asset, with the intention of misrepresenting the volume and value, and then selling it later to an unsuspecting third party. While Chainalysis reports most wash traders are unprofitable, mainly due to royalties and commissions to NFT exchanges, some players have been successful in duping investors into believing they are buying into a highly-demanded NFT.[17] Money laundering using NFTs is also a major headwind for an asset class vying for legitimacy. However, analysis to date suggests that only a small percentage of total NFT transactions are for money laundering purposes, and so far are an even smaller percentage when compared to traditional art or money markets.

Summary

The NFT market is still relatively small compared to the broader digital asset or "crypto" economy, with Chainalysis reporting an estimated $44 billion spent on NFTs in 2021 versus an estimated $2 trillion market cap for publicly traded crypto assets.[18] However, the explosive growth of issuance, transaction volume, and application of the NFT data type is likely to continue as platforms provide easier access, regulations become clear, and education continues to permeate the masses outside today's crypto-native community. Art, music, film, real estate, gaming, and more industries are likely to begin incorporating NFTs for new customer and fan experiences, engagement models and revenue streams. Booms and busts will occur in the NFT space as they do throughout all markets, and issuers, collectors, and investors alike need to be aware of the potential pitfalls and promise of this burgeoning market.

[16] "PYMNTS NFT Series; Can NFTs be Securities? The SEC Says Yes (Link)," PYMTS.com, January 12, 2022.

[17] "Crime and NFTs: Chainalysis Detects Significant Wash Trading and Some Money Laundering in This Emerging Asset Class (Link)," Chainalysis, February 2, 2022.

[18] "Report Preview: The 2021 NFT Market Explained [UPDATED 1/13/22] (Link)," Chainalysis.

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Art and Money Laundering: Shifting Regulatory Tides



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Art and Money Laundering

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From time to time, headlines announce that "another" case of money laundering in the art world has been uncovered, followed by the argument that it is merely "the tip of the iceberg." Whether or not such an extrapolation is justified, several countries around the world have responded by proposing or enacting laws and regulations specifically geared towards the art market. These laws and regulations require certain art market participants to help prevent and detect money laundering in their operations.

In light of these developments, it is important for art market participants to know which rules apply to them and what they can do to avoid unwittingly participating in a money-laundering scheme. The good news is that, in general, anti-money laundering (AML) requirements are "risk-based" and align well with common risk management approaches and thoughtful strategies for long-term sustainable success.

This article aims to raise awareness of the money-laundering risks collectors and family offices may face, and to offer some ideas on how they can mitigate those risks. Readers are encouraged to seek competent advice from legal and compliance professionals in order to maximize their AML impact.

Background

What Is Money Laundering?

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) defines "money laundering" as:

> *"…the process of making illegally-gained proceeds (i.e., 'dirty money') appear legal (i.e., 'clean'). Typically, it involves three steps: placement, layering and integration. First, the illegitimate funds are furtively introduced into the legitimate financial system. Then, the money is moved around to create confusion, sometimes by wiring or transferring through numerous accounts. Finally, it is integrated into the financial system through additional transactions until the 'dirty money' appears 'clean.'"* [19]

FinCEN warns that money laundering can "facilitate crimes such as drug trafficking and terrorism, and can adversely impact the global economy."

Scope of the Problem

Money laundering is a serious, worldwide problem. It is estimated that about 3-5% of global GDP is laundered globally every year, equaling an astounding $2.17 trillion to $3.61 trillion.[20]

Money laundering has also been linked to terrorist financing, which encompasses the means and methods used by terrorist organizations to finance their activities. Terrorist groups often obtain their financing from illegal activities such as trafficking in weapons, drugs, people, and stolen goods. Funds derived from these crimes are then laundered to make them usable in commerce. Because of this link, anti-

[19] "History of Anti-Money Laundering Laws (Link)," U.S. Financial Crimes Enforcement Network, accessed February 17, 2022.

[20] "Anti-Money Laundering / Counter Terrorist Financing (Link)," U.S. Department of State, accessed February 17, 2022.

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money-laundering and combating the financing of terrorism (AML/CFT) are often discussed in the same breath.

Vulnerability of the Art World

The art world at large appears to be an appealing target for criminals with large sums of dirty money to launder, ostensibly exploiting certain inherent features of the art world, including:

- large sums of money changing hands on a daily basis;
- a lack of comprehensive AML regulations applicable directly to all art market participants;
- a lack of transparency, based in tradition and the desire for privacy;
- common use of intermediaries, contributing to the lack of transparency;
- challenges in accurately documenting provenance;
- portability of most art objects, easing cross-border transactions and concealment; and
- subjective valuation of artworks leading to high volatility and potential for abuse.

In theory, criminals could use art to launder dirty money in different ways. First, they could purchase artworks with dirty money and later sell those artworks in exchange for clean funds. Second, they could use art previously purchased with dirty money as collateral for loans. And, finally, they could hide a transfer of dirty money by over- or under-invoicing the purchase or sale of a work of art.

United States

While art market participants as such are not yet subject to AML regulations, it is important to remember that the participation in a money-laundering scheme can, nonetheless, be a federal crime, punishable by imprisonment and severe financial penalties. That can be the case if a person who plays a part in such a scheme ***knew or should have known*** that the proceeds of a specified unlawful activity (e.g., drug deals, embezzlement, stock manipulation) are laundered (1) to promote that activity; (2) to avoid taxes; (3) to conceal or disguise the nature, location, source, ownership, or control of the proceeds; or (4) to avoid certain reporting requirements.

A person “knows” that the property in question represents proceeds of some form of unlawful activity if that person has “direct knowledge” (e.g., “please take this drug money and launder it for me”), or if that person was aware of facts giving rise to a high probability of a money-laundering scheme (e.g., “please accept this bag of $50,000 in rubber-banded $20 bills”), or consciously avoided knowledge (e.g., “don’t tell me how you made this money — I’d rather not know”).

Trade-based money laundering (TBML) appears to be particularly suitable to the art trade. For that method of money laundering, criminals would use the legitimate trade to disguise their criminal proceeds. The method involves any one of several schemes to complicate the documentation of legitimate trade transactions, as for example:

- moving illicit goods;

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- falsifying documents;
- misrepresenting financial transactions; and
- under-invoicing or over-invoicing the value of goods.

Art market participants are, therefore, well advised to take great care when completing or checking documentation and to conscientiously avoid any incorrect valuations or other material misrepresentations.

U.S. AML Laws and Regulations

U.S. AML laws, including the Bank Secrecy Act ("BSA") and related regulations, are designed to help identify the source, volume, and movement of currency in order to assist U.S. government agencies in detecting and preventing money laundering. The laws cover banks and certain enumerated non-bank financial institutions, including casinos, securities and commodities firms, insurance companies, pawnbrokers, loan or finance companies, operators of credit card systems, and dealers in precious metals, stones, or jewels. In early 2021, Congress amended the BSA in a number of ways relevant to the art market.

Antiquities Trade to Be Covered by AML Regulations

The January 2021 law added another type of "financial institution" to the above list of financial institutions:

> *"…a person 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."*

Final regulations for these new covered entities will likely be issued sometime in 2022. While it is not yet clear what exactly these regulations will require of the antiquities trade, the regulations may well resemble the ones already in place for "***dealers in precious metals, stones, or jewels***" (31 C.F.R. Part 1027), which include:

- The written AML program:
  - Policies, procedures and internal controls
  - Risk assessment
  - Compliance officer
  - Education and training
  - Independent testing
- Reporting
- Record-keeping
- Information sharing

The regulations for the trade in antiquities will most likely also contain definitions of central terms (e.g., antiquities, trade) and may exempt certain dealers based on size and/or annual revenue.

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Art Market Study

The January 2021 law also commissioned a "Study of the Facilitation of Money Laundering and Terror Finance Through the Trade in Works of Art," obligating the Treasury Secretary to research money laundering and terrorist financing in the art market. On February 4, 2022, the Treasury Department released the results of the study.[21]

The study concluded that, compared to other industries with higher money-laundering risk, "the art market should not be an immediate focus for the imposition of comprehensive AML/CFT requirement." The study determined that AML/CFT risks are not equally distributed across the U.S. market. Instead, while there is some money-laundering risk in the ***institutional, high-value*** art market and possibly in the ***emerging online*** art market, there is little evidence of terrorist finance risk.

Based on the perceived risk of money laundering in different sectors of the U.S. art market, the study recommended that companies which provide art financing services, such as art lending firms and auction houses with lending programs, should be covered by AML/CFT requirements; if other art market participants were to be regulated, entities with annual sales of less than $500,000 or $1 million should be exempted. Instead, small- and medium-sized art businesses should be assisted through the creation of an "information sharing mechanism" that would facilitate customer due diligence efforts without disproportionately increasing compliance burdens.

Pandora Papers and Aftermath

Following the Panama Papers (2016) and Paradise Papers (2017), on October 3, 2021, the "Pandora Papers" were published by a number of news organizations, leaking close to 12 million documents from 14 offshore financial services firms. The documents included information on more than 330 politicians and public officials from more than 90 countries and described the practice of using shell companies and trusts to hide billions of dollars, often to avoid the reach of tax authorities and law enforcement. One case described in the documents that received a lot of attention was that of Donald Latchford, an art dealer and leading scholar of Khmer art. Before his death in 2020, he was accused of trafficking in looted Cambodian art. The Pandora Papers reported that money related to the allegedly looted artworks passed through offshore accounts associated with Latchford.

Just a few days after the Pandora Papers were published, the "ENABLERS Act" (H.R. 5525) was introduced by a bipartisan group of federal lawmakers. The Act would add a number of art market participants to the BSA's list of financial institutions:

> *"…a person engaged in the **trade in works of art, antiques, or collectibles**, including a dealer, advisor, consultant, custodian, gallery, auction house, museum, or any other person who engages as a business in the solicitation or the sale of works of art, antiques, or collectibles."*

In addition to those art market participants, the ENABLERS Act would also add several other categories of people and entities to the list, including lawyers and law firms, accountants, realtors, investment advisers, and public relations firms.

[21] "Treasury Releases Study on Illicit Finance in the High-Value Art Market," U.S. Department of the Treasury, press release dated February 4, 2022.

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Whether the ENABLERS Act or a similar bill will be enacted in the United States is an open question. What is not in doubt, however, is that the U.S. government and the greater public are laser-focused on the art market, with several voices forcefully demanding broad AML regulations for art market participants. The worldwide pressure for more transparency in the art world seems to have an effect on U.S. lawmakers. Stay tuned!

The European Union and United Kingdom

European Union

As part of a comprehensive attack on money laundering and terrorist financing, the EU has issued a series of Anti-Money Laundering Directives. EU Directives require each Member State to enact domestic legislation that meets a minimum standard, including (1) risk assessment, (2) customer due diligence, (3) record-keeping, and (4) suspicious transaction reports.

The Fifth Anti-Money Laundering Directive (5AMLD) required Member States to enact domestic laws by January 2020 that specifically cover certain art market participants (persons trading works of art, including art galleries; auction houses; persons storing or trading works of art "when this is carried out by free ports;" intermediaries) if the value of a transaction is € 10,000 or more (including a series of linked transactions and any payment method).

The requirement to conduct customer due diligence is stricter for a number of cases set forth in 5AMLD's Annex III because they indicate a "potentially higher risk," including:

> *"…transactions related to oil, arms, precious metals, tobacco products**, cultural artefacts and other items of archaeological, historical, cultural and religious importance**, or of rare scientific value, as well as ivory and protected species."*

Such riskier transactions require "enhanced customer due diligence" (EDD), meaning that the covered entity must ask more questions and request more documentation from its business partner.

5AMLD also introduced some provisions for the purpose of increasing transparency, including central registers for ultimate beneficial ownership (UBO) information that must be created in each EU Member State; a new EU Platform will connect these central registers. Access to the information in the registers will be given to law enforcement and entities required to perform due diligence, among others.

The Sixth Anti-Money Laundering Directive (6AMLD) had to be implemented by each Member State by June 3, 2021. Among other things, 6AMLD raised criminal penalties across the EU. For example, in addition to persons who profit directly from acts of money laundering, 6AMLD added aiding, abetting, inciting, and attempting to launder money as covered offenses.

In July 2021, the European Commission introduced a bold set of legislative proposals to strengthen the EU's AML rules, including a proposal for the creation of a new EU authority to fight money laundering. Until this new regulation becomes effective, each Member State has a different law: 5AMLD and 6AMLD provide a minimum set of rules, and a number of Member States have already enacted stricter rules than required by the EU Directives. Art market participants should, therefore, consult knowledgeable counsel in each Member State in which they are doing business.

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United Kingdom

In the U.K., "art market participants" are subject to anti-money laundering and terrorist finance regulations. Because these regulations were enacted when the U.K. was still a member of the EU, the U.K. regulations very much resemble the above-described EU regulations. Even after Brexit, the U.K. has continued its leading role in combatting money laundering and terrorist financing.

One important obligation for art market participants in the U.K. is the duty to register with HM Revenue & Customs. See the U.K. government's website (Link) for more information.

The required customer due diligence (CDD) process includes:

- request documents: picture ID, recent proof of residential address;
- request UBO information for companies, trusts, etc.;
- inquire into the purpose of planned transaction and source of funds;
- consult watch lists (e.g., government sanctions, "politically exposed persons" (PEPs), etc.);
- react to "red flags" by conducting EDD; and
- keep records

Other obligations resemble those in effect in the EU: the U.K. rules require staff training, the appointment of a "money laundering reporting officer" (MLRO) and deputy, as well as the submission of "suspicious activity reports" (SARs).

Suggested Approached for Collectors and Family Offices

As the above overview makes clear, collectors and family offices are well advised to consider adopting carefully tailored AML programs. There is no "one size fits all" approach, and any program should be based on the results of the particular collector's or family office's risk assessment. An AML program should be reasonably designed to prevent the collector or family office from being used to facilitate money-laundering activities through the purchase and sale of covered goods.

What is essential to meet regulatory expectations is: (1) that the collector or family office make a reasonable effort to mitigate the risks it faces, and (2) that it be able to document all measures it implemented and steps it took in mitigating those risks, including that "red flags" were followed up on. In many organizations, existing risk management, accounting, auditing, and other practices may provide a roadmap for an effective AML program, and existing personnel may be able to take on all or most of the new duties.

In any event, a robust AML program can be one piece of a long-term strategy for sustainable success. While the new obligations may place a significant compliance burden on art market participants in the short run, they may prove to be blessing in disguise in the long run — when they protect art market participants from becoming unwitting participants in money-laundering schemes. An effective AML program can protect an organization from a government investigation, criminal prosecution, civil litigation by affected business partners, and the related legal fees; it can also prevent harm to the organization's reputation as a result of negative publicity.

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Most people prefer to do business with ethical organizations that have safeguards against money laundering in place. Because transparency leads to trust, collectors and family offices should regard AML procedures not as a challenge, but rather as an opportunity and possibly even a differentiator.

For more detailed, practical guidance on how to get started, art market participants are encouraged to visit the website (Link) of the Responsible Art Market (RAM) Initiative — a non-profit, cross market initiative formed in Geneva in 2015. For example, the RAM Guidelines on combatting Money Laundering and Terrorist Financing offer step-by-step suggestions on how to approach AML risk mitigation:[22]

1. Do a risk assessment of your business and apply risk based measures
2. Know and comply with the laws where you are doing business and be alert to "red flags"
3. Know Your Clients (KYC) and establish their risk profiles: Check for client red flags
4. Research the artwork, its ownership and provenance: Check for artwork red flags
5. Know the background and purpose of transaction: Check for transaction red flags
6. Keep records
7. Train staff and monitor processes and procedures
8. If grounded suspicions exist, know how to act

On the RAM website, each of the above eight guidelines leads the user to more detailed suggestions on how to handle the issue. The website also offers (non-exhaustive) Lists of Red Flags, which can assist in identifying circumstances that would warrant further inquiry or, potentially, the rejection of a particular deal.

[22] "Guidelines on Combatting Money Laundering and Terrorist Financing Link ," Responsible Art Market, accessed February 17, 2022.

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What's New for Art in 2022? Trends Emerge in a Time of Crisis



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Timeline - Art Disruptors

The history of Western Modern art has long celebrated the "avant-garde," those artists, art works or movements who have fore fronted innovation and have broken the rules, often to much controversy. The intersection of art and NFTs offers a new chapter in this ongoing history of radical disruption. Here we take a look back at those who have pushed the boundaries of art making and art marketing over the last 150 years.



1870s-1880s

THE IMPRESSIONISTS

Not only did the Parisian-based painters create an uproar with their contemporary subject matter and loose brushstrokes, but their application of scientific theories of color and light was considered especially extreme. Just as revolutionary was their outright rejection of the institutional Academy with its annual salon exhibitions. This denunciation resulted in the rise of the art dealer system, introducing a radical new way of displaying and selling art.

1910s-1920s

DADA AND THE READYMADE

Against the brutality of World War I, Dada sought to destroy conventional ideas about art, particularly that it had to be beautiful. One of the leaders of the movement, Marcel Duchamp, epitomized the subversive Dadaist attitude with his "Readymade" sculptures like The Fountain (1917), in which a mass-produced urinal became a work of art because the artist designated it as such. Antithetical to skill and aesthetic, Dada art appealed to the mind and encouraged complete artistic liberation.



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1950s-1970s

FROM HAPPENINGS TO CONCEPTUAL ART

Artists from Asia, South and North America, and Europe staged performances and "Happenings" that disputed the convention that an artwork could only exist as a physical object. Foregrounding audience participation that converted viewer into creator, these ideas would find further expansion in Conceptual art, which argues that the idea, as opposed to an artwork's "object-ness," is its most significant feature. This challenged the commodification of art and questioned the authority of the art dealer and gallery.





1980s-1990s

STREET ART AND RISE OF AUCTION HOUSES

Street and graffiti art, epitomized by artists including Jean Michel Basquiat and Keith Haring, made art accessible to a broader audience, often by relocating it from the walls of the gallery to the spaces of their communities. Artists like Cindy Sherman and Richard Prince of the Pictures Generation appropriated elements of mass media and culture, throwing into question the concept of artistic originality and ownership. Meanwhile auction houses redefined themselves as global purveyors of luxury goods and saw record prices, a phenomenon spurred by the concept of art as an investment vehicle along with the ascendency of contemporary art as a market category.

2010s-2020s

TECHNOLOGY, THE INTERNET, AND NFTs

Online buying platforms and social networking services like Instagram and have transformed how information is shared and traded, propelling the art market's extraordinary growth across the globe. The NFT market has radically democratized ownership of digital art by being easily traded in the secondary market without the need for any traditional art market intermediaries. Digital artists can monetize their work in a more equitable manner, and redefine the relationship they have with the market and audiences.



What's New in 2022 for Art?

Trends in the Art Market Emerge in a Time of Crisis

Betsy Bickar
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Citi Private Bank

No one could have imagined the challenges that 2020 presented to the art market: the threat of a pandemic halting nearly all commercial activity was more than daunting. The situation had sprung economic and logistical challenges upon the art world that not only created uncertainty, but also made many uneasy about the market's entire structure and outlook. Globally, artists, museums, and art dealers all faced unique challenges, and their survival hinged upon the ability to quickly adapt. Although pre-pandemic many of us had been feeling an unsustainable level of "art-fair and auction fatigue," these events still provided the majority of a gallery's or artist's annual revenue. Would we ever get back to visiting galleries, museums, art fairs, and auctions in the same way? How would artists, museums, and small galleries endure this level of economic crisis?

Fast forward to December 2021: in just a two-week span at the November auctions, $2.3 billion dollars of art sold — up 173.9% from the previous year.[23] Art Basel Miami Beach ended the year with a bang, marked by lavish parties and performances by Cardi B, Alicia Keys, and Lizzo, even amid global concerns about COVID-19's recently identified Omicron variant. Approximately $10.7 billion dollars of art minted as non-fungible tokens (NFTs) sold as of the third quarter of 2021.[24] As 2022 begins, dealers are now reporting a new energy in the overall art market, with a resurgence of in-person events and venues.

There were other changes in 2021, some unrelated to the pandemic: increased regulation around anti-money laundering and strong sales of the scions of Postwar, Modern, and Impressionist art.[25] New auction house-gallery relationships also emerged as the sense of artistic community prevailed over commercial interests. In the absence of the physical, the purely digital started to take hold in more ways than one. A new comfort level of buying art online and sight-unseen is evident. Artists, museums, and dealers quickly adapted to a more digital world and managed to survive — and many even thrived — in these unprecedented times. The art market has proven to be beyond resilient — it seems to be almost unstoppable, far-reaching, and quickly evolving. Here are some of the biggest trends we have seen this year.

[23] Price indicated includes auction house premiums. Kelly Crow, "The Art Market Surges, Selling $2.3 Billion in Works," *The Wall Street Journal*, November 19, 2021; Lindsay Dewar, "Marquee Evening Sales," ArtTactic, November 2021.
[24] Gregory Bobillot "Soaring NFT Sales Redraw the Art Market", *FT*, November 28, 2021.
[25] Judd B. Grossman et al., "New U.S. Anti-Money Laundering Laws and Sanctions Advisory Impose Compliance Obligations on Art Market", ARTnews, March 30, 2021.

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New Collectors and Shifting Genres

A wider range of people now have access to the art world than ever before. Indeed, anyone with a smartphone or computer can buy art online, not just those on coveted VIP lists. As such, we have seen a rapid increase in buying from a more global collecting base, with younger collectors making their presence felt. A recent Artsy survey found 83% of the respondents said they had purchased art online. That share was even greater among "Next-Gen collectors," a subset of buyers who had started collecting in the last four years and had spent at least $10,000 on art in a given year, 91% of whom said they have bought art online."[26]

Galleries have long focused on the careers of living artists, but auction houses have only begun to tap this sector. While auction houses rarely take primary market consignments directly from artists, that model is changing as 2022 begins. Auction houses are in the stages of planning exhibitions in conjunction with galleries to partner in new ways. Large galleries such as David Zwirner, Jeffrey Deitch, and others have created online platforms and formalized relationships with younger, more emerging galleries.

Figure 8. Kwesi Botchway, *Green Sofa*, 2020 — Acrylic on canvas 60 1/4 x 55 in. (537 x 139.7 cm) at Phillips 20th Century and Contemporary Evening Art, November 17, 2021 for $214,200 with premium



Source: Image courtesy of the artist

[26] Benjamin Sutton, "Artsy Insider: How the Next Generation of Collectors Is Buying Art," Artsy, June 30, 2021.

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A trend that began to take hold a few years ago strengthened dramatically in 2021, with a continued interest in a more diverse artistic output in the Contemporary sector. In fact, semantics around what is "Contemporary" art are shifting, with auction houses and galleries talking about "21st Century art" or "The Now." The "new" is even more in vogue than ever before — record prices for less established or relatively unknown artists are now so common that many wouldn't even refer to it as speculative anymore. Auction houses are finding that collectors who are interested in Impressionist and Modern artworks are also increasingly drawn to Contemporary.

Phillips began its "New Now" sale of ultra-contemporary art several years ago to present an edited selection of emerging art. This sale has steadily been gaining traction among younger buyers and 2021's insatiable appetite was further evidence of that. Christie's and Sotheby's have also traditionally held midseason sales, dubbed "First Open" and "Contemporary Curated", respectively. However recently, instead of taking a backseat, these types of sales — which are made up of younger, more diverse, and lesser-known artists — arrived in a prominent spot in New York's marquee week, each auction house taking a slightly different approach but all markedly focusing on the "new", or ultra-contemporary work that typically wouldn't have been seen at auction for a number of years to come. For example, Phillips now designating their 2021 New York sale "20th Century & Contemporary Art", to distinguish between a Joan Mitchell from 1992 and a Jadé Fadojutimi from 2018, illustrates how different artmaking has become in a short span of time, and how it speaks to diverse collector bases. Underscoring the further classification of the term "Contemporary Art," Sotheby's mounted a standalone sale called "The Now," and Christie's hosted two separate sales: "20th Century Evening Sale" and "21st Century Evening Sale."

Changing Tastes

As audiences become more diverse, so too does the art that speaks to them. Museums, particularly in North America and Europe, have facilitated this by focusing on historically underrepresented and marginalized artists and movements. Academic institutions and private collectors are reshaping the art historical canon, which is now drawing long overdue attention to women, artists of color, and other demographics. These complex narratives are the subject of museum exhibitions and reinstallations of many permanent collections across the United States and Europe.

The increasing diversity of figurative painting is a case in point. Over recent years, market successes such as Kerry James Marshall, Kehinde Wiley, and David Hammons have paved the way for the markets of other artists to grow and flourish. Among them are Lynette Yiadom-Boakye, Amy Sherald, Jordan Casteel, Titus Kaphar, Mickalene Thomas, Calida Rawles, and Toyin Ojih Odutola.

Level Playing Field

The rarefied and academic art market has traditionally been an insiders' club that rejected more commercial and less esoteric works. However, that has now changed. Galvanized in part by the Asian contemporary market, along with the emergence of newer, younger collectors globally, there has been a significant shift in collecting tastes. Newer collectors do not always have the preconceived notions that fine art should be "important" or "serious." Instead, a broad base of collectors and even museums have embraced a more open way of thinking about what constitutes fine art.

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Digital art, cartoons, youth culture imagery, graphic design, and toys are now much more in vogue. Early in 2021 many — including me — were wondering "what is an NFT?" Yet the market adapted rapidly, and art works minted as NFTs now feature regularly in auction sales, and galleries are participating as well. A new digital medium has captivated the art world, with galleries, museums, and collectors wanting in on the action.

Figure 9. Still Image from Beeple's Open-Source Short Film *FITC TORONTO TITLES*



Source: Beeple website

Amid this democratization of the art world, there is widespread celebration of artists who work outside of the mainstream. One example is the street artist known as Banksy. His *Love Is in the Bin* sold in 2021 at Sotheby's London for £18.6 million ($25.4 million). This work famously sold three years prior at Sotheby's for £1 million ($1.4 million). As the gavel struck, surprised auction-goers watched as the work shredded itself. This stunt in the end created a new, "damaged" work that later resulted in yet another record price for the artist.

Another example is graffiti-artist turned fine-artist KAWS (aka Brian Donnelly), who was the subject of a major retrospective in 2021 at the Brooklyn Museum of Art, achieving record ticket sales. What is surprising about this is the artist's career trajectory (his work frequently references characters from Sesame Street, SpongeBob SquarePants and Mickey Mouse) is that he was outside of any current artistic trend or intellectual movement until recently. Tagging trains as a graffiti artist since the 1990s, KAWS later trained at the School of Visual Arts in Manhattan. Instead of working with an art gallery, he opened a store to sell his own collectibles in Tokyo. His images were worn on clothing by some of music's biggest names in the early 2000s — Jay-Z, Kanye West, Swizz Beatz, and others. Some years later, he created partnerships with major retail brands like Dior and Uniqlo. He eventually found gallery representation in 2008 but it wasn't until 2019 when *The KAWS Album* a painting of the Simpsons characters, sold at Sotheby's Hong Kong for an astounding $14.8 million dollars that collectors across the globe took notice and could no longer exclude this international sensation from the art world at large.[27] Prior to the sale, *The KAWS Album* had been estimated to sell around $1 million dollars. There was no denying the market for KAWS' work, and his 2021 Brooklyn Museum exhibition solidified the artist as part of a cultural movement.

[27] M.H. Miller, "The Surprising Ascent of KAWS," *The New York Times Magazine*, February 9, 2021.

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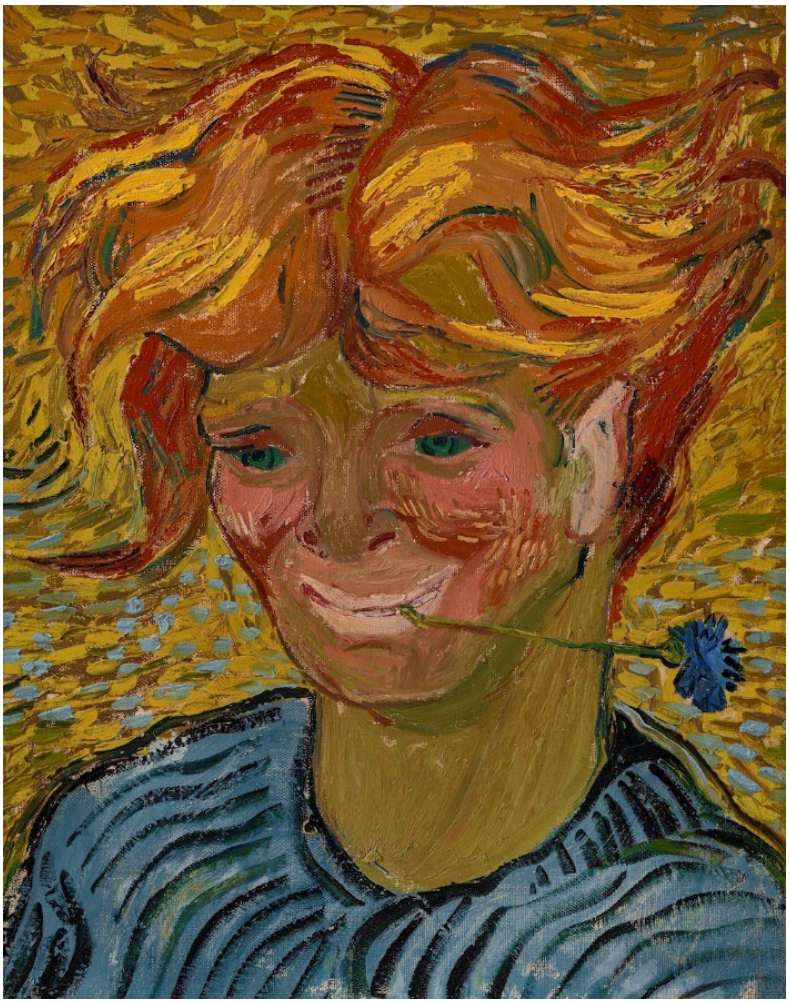
No Auction Slowdown for Impressionist and Contemporary Classics

Not everyone is buying Banksy, KAWS, and NFTs, however. There is still a strong market for more historical artworks, as evidenced by the Cox Collection sale at Christie's in November 2021. A single-collection sale belonging to the late oil tycoon Edwin Lochridge Cox achieved a stunning $332 million dollars, including fees. Sixteen works were backed by third-party or in-house guarantees, including the star lot, *Jeune homme à sa fenétre* (1876) by Gustave Caillebotte. This painting sold to an advisor on behalf of the Getty Museum in Los Angeles for $53 million dollars, including premium, against an estimate of $50 million dollars, which was a record for the deceased artist. The combined total of the three van Goghs reached $147.8 million dollars with premium, with one work entitled *Jeune homme au bleuet* (1890), selling for $46.7 million dollars, exceeding its conservative $5 million to $7 million dollar estimate. This colorful, engaging, and almost contemporary style of painting appealed to collectors worldwide, not just Impressionist experts. Three other auction records were also set in the sale, which was an example of highly coveted and important group of works that had never been sold publicly.

Figure 10. Vincent van Gogh, *Jeune homme au bleuet*, 1890 — Oil on canvas 16 x 12-5/8 in. (40.5 x 32 cm). Sold at Christie's The Cox Collection: The Story of Impressionism sale, November 10, 2021 for $46,732,500



Source: CHRISTIE'S IMAGES LTD. 2022

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As the Contemporary market raged on, the highly anticipated sale of The Linda and Harry Macklowe collection at Sotheby's in November 2021 did not disappoint. Built over decades, the blue-chip collection of mostly 20th Century masterworks by blue-chip artists including Robert Ryman, Willem de Kooning, Cy Twombly, Andy Warhol, and many others, achieved a jaw-dropping $676 million dollars in a single evening's guaranteed sale. One of the top lots was a vibrant, and arguably joyful, Mark Rothko, *No. 7*, 1951, which sold to a collector in Asia for $82.5 million dollars.[28]

In the same auction cycle, Christie's 20th Century sale achieved $420 million dollars in a single evening. Andy Warhol's portrait of Basquiat sold for over $40 million dollars with fees, doubling its "on request" presale estimate of $20 million dollars.

Phillips' November 2021 20th Century & Contemporary Art evening and day sales totaled $172.5 million dollars, a record for the company.

Sotheby's reported a total of $7.3 billion dollars in art sales in 2021. Its private sale volumes were up by one-third over 2020 levels, with the auction house citing an influx of younger buyers and their allowing payment with cryptocurrency for certain lots.[29]

Records were set for many different artists in 2021, including Frida Kahlo, whose 1949 self-portrait at Sotheby's sold in November for $34.9 million dollars. Highly coveted works like this are even rarer given the fact that it is one of only a handful in private hands and in free circulation outside of Mexico. This sale set the current top auction record for a Latin American artist of all time. In addition to these public auctions, the major houses are also beginning to organize smaller and more exclusive invitation-only auctions.

Increased Sales Volume Brings Greater Transparency

It is no secret that the art market has long been opaque and unregulated. Although it is slowly shifting to a model of increased transparency, many aspects remain stuck in the old mentality of the "handshake deal" — no paperwork, verbal agreements that bind multi-million dollar deals, and transactions based simply on trust and old friendships. However, in the Anti-Money Laundering Act of 2020, the U.S. Congress passed a new regulation which now includes any "person 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" in its definition of a financial institution. Because galleries typically have not had the infrastructure to handle such monitoring, many have partnered with large auction houses to attempt to meet compliance goals of the new regulation. Regardless, even more stringent sellers were cited to have had gaps in the monitoring system, according to the U.S. Senate's Permanent Subcommittee on Investigations. This legislation is similar to the European Union's previously enacted Fifth Anti-Money Laundering Directive, which includes, but is not limited to, extending certain anti-money laundering and counter-terrorism financing rules to art dealers.

[28] Robin Pogrebin, "Blue-Chip Art From Bitter Macklowe Divorce Brings $676 Million at Sotheby's," *The New York Times*, November 15, 2021.
[29] Kelly Crow, "Sotheby's Sells $7.3 Billion in Art, Fueled by Moneyed Millennials," *The Wall Street Journal*, December 15, 2021.

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Subsequent to the legislation, in February 2022, after interviewing dozens of dealers, auction houses, and other art market participants, the U.S. Department of the Treasury concluded that it is not necessary to increase regulation on sales by galleries and auction houses at this point in time, as terrorism financing using art is a relatively low risk. Additionally, they found that cash is rarely used to purchase art, and even in those cases, financial institutions are already required to report high-value cash transactions. They also found that many dealers already take measures to perform appropriate due diligence on buyers, but cautioned that NFTs could present new money laundering risks, and recommended sharing of information ongoing training for regulatory officials on art-related financial crimes.[30]

What's Next?

If 2022 is anything like 2021, we can expect the art market to grow and evolve further and faster. New participants will continue to enter, and different perspectives and narratives will critically influence both art-historical and art-market conversations.

New synergies are forming between galleries and auction houses, artists, and collectors and even among competing galleries. Auction houses and art fairs are homing in on new collectors, a growing global collector base, and are finding new ways to maintain the allure of exclusive and VIP access even as swaths of new participants enter. Dealers and auction houses report that the growth of private sales remains on a strong upward trajectory. New ways to buy art keep emerging, as the old ways persist, yet adapt to a changing transactional model. As the art market expands exponentially, regulation is tightening in both Europe and in the U.S. Digitalization and globalization have accelerated the pace of change, and we can certainly anticipate further evolution of this fast-moving and dynamic art market.

[30] "Treasury Releases Study on Illicit Finance in the High-Value Art Market," U.S. Department of the Treasury, press release dated February 4, 2022.

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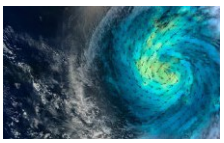

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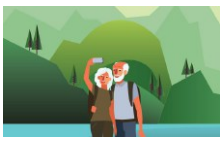

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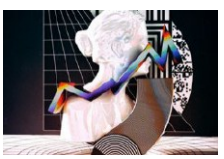

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NOW / NEXT

Key Insights regarding the future of the Global Art Market

INNOVATION

The art market has long dominated by the old mentality of the 'handshake deal" with no paperwork, verbal agreements that bind multi-million dollar deals and transactions based simply on trust and old friendships. / NFTs are disrupting the ownership model of art and democratizing the ownership of digital art by building an infrastructure that creates unique, traceable and undisputed ownership records of a digital artwork.



SHIFTING WEALTH

Millennials are increasingly entering the art market and exerting their demand for online and mobile offerings. A survey of "NextGen Collectors," showed 91% had bought art online. / The rise of Millennial art buying underscores the digital imperative and signals more sweeping change across the industry.



SOCIAL CHANGE

The shift to digital has widened the range of people who have access to art. As the audience for art becomes more diverse, so does the art that speaks to them. / Academic institutions and private collectors are reshaping the art historical canon, which is now drawing long overdue attention to women, artists of color, and other demographics.



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