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Will ESG Finance in Europe **go from E to S**?

Diana-Elena Dona[1] *& Marcin Krzemień*[2]

Abstract: ESG has become a mainstream topic in finance. There has been an increased interest in sustainable financial products among key stakeholders – businesses, investors and most recently governments and regulators. In Europe, decarbonisation and transition to a circular economy have become some of the main points on the EU's political agenda. However, the focus so far has been on the "E" in ESG, and climate in particular. This article discusses recent developments in regulation of ESG finance on the European level, in particular (i) the relevant EU legislation; (ii) how and why EU regulation of sustainable finance gives priority to environmental issues, (iii) risks which may result if the EU regulatory agenda continues to ignore social finance, with the risk of "social-washing" being at the forefront, and (iv) nascent efforts to address social aspects of sustainable finance by creating a taxonomy of socially-sustainable activities in EU law.

1. Introduction

Issues relating to environmental, social and governance (ESG) factors and related risks have recently become more salient in the financial sector. Within the broader ESG discussion, the financing aspect of ESG is particularly important as efforts to promote ESG considerations generally require significant amounts of capital.[3]

More and more financial sector actors, both private and public, are adopting sustainable finance and investment policies[4] International financial institutions such as the International Financial Corporation (IFC) or the European Bank for Reconstruction and Development (EBRD) have done pioneering work in sustainable finance, having been among the first entities to set out and implement their own ESG policies.[5]

The European Union has been eager to regulate sustainable finance in recent years. Below we begin by examining the development of EU regulation in the field. Second, we show how and why the EU's sustainable finance initiatives have so far focused mainly on environmental issues. Finally, we consider recent EU regulatory developments in the sphere of social finance with particular attention to the proposed social taxonomy, including the rationale behind such an instrument and the associated risks. We conclude the article by considering the potential importance of European sustainable finance regulation for legal practitioners in international financial institutions.

2. Regulation of sustainable finance in EU law[6]

The fledgling European system for regulating sustainable finance has its roots in 2 strategic documents – the 2018 *Sustainable Finance Action Plan*[7] and the 2021 *Strategy for*

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[3] See e.g. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions: *Strategy for Financing the Transition to a Sustainable Economy* (COM/2021/390 final).

[4] See e.g. the UK's *Green Finance Strategy* (2019) available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf or the Letter to CEOs, Power of Capitalism from the CEO of Blackrock (2022) available at: https://www.blackrock.com/ch/individual/en/2022-larry-fink-ceo-letter (access: 4 Oct. 2022).

[5] EBRD had a detailed environmental and social policy as early as in 2008 (and an environmental one already in 2003) and the IFC implemented a sustainability policy in 2006 – see: https://www.ebrd.com/downloads/research/policies/2008policy.pdf and https://www.ifc.org/wps/wcm/connect/f12fa7cb-267e-442b-ab9d-58f371b9198a/SustainabilityPolicy.pdf?MOD=AJPERES&CVID=kpl-B8K (access: 4 Oct. 2022).

[6] One of the co-authors, M. Krzemień has prepared a PhD dissertation titled: *The protection of environment in EU law of financial markets* at the University of Warsaw (in Polish) in which the EU environmental finance regulatory agenda and issues relating to supervision thereof discussed below are covered in much more detail including an analysis of the systemic importance of environmental risks. Dissertation is not yet published, to be reviewed and published in 2023.

[7] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of Regions: *Action Plan: Financing Sustainable Growth* (COM/2018/097 final).

financing the transition to a sustainable economy.[8] It includes the following components:

- taxonomies allowing for easier identification of economic activities with an ESG component;[9]
- ESG reporting obligations, which aim to allow investors to better assess the ESG performance of certain corporate entities;
- prudential regulations for financial institutions aiming to increase their resilience to ESG risks; and
- financial product regulations facilitating ESG investments (including product distribution rules).

The EU regulations are designed to encourage market participants to assess the impact of ESG factors on their activities from both the *outside-in perspective* and the *inside-out perspective*. The *outside-in perspective* assesses how a company may be impacted by ESG factors while the *inside-out perspective* assesses the impact that the activity of a company may have on ESG objectives.[10] In the financial sector, the outside-in perspective involves considering how ESG factors may affect the ability of a business to produce returns for investors, while the inside-out perspective considers how financing a particular venture may affect ESG objectives.

This regulatory agenda forms part of a broader EU effort to promote sustainable economic activity. Most notably, the proposed Corporate Sustainability Due Diligence Directive will require selected large corporate entities to introduce due diligence policies with respect to ESG considerations (environment and human rights), such as codes of conduct (on the positive side) and processes allowing them to identify and mitigate negative effects on ESG factors (on the negative side).[11] The Directive also requires the imposition of duties on directors of the relevant entities to take account of ESG factors. If enacted, the Directive will have broad implications for the financial sector as well—if the affected corporates are required to internalize their impact on ESG objectives then this should be reflected in their valuations.

3. The EU environmental taxonomy

Regulation 2020/852[12] has introduced a taxonomy of environmentally sustainable economic activities (the "Taxonomy"). The Taxonomy enumerates 6 strategic environmental goals and lays out a taxonomy of economic activities which significantly contribute to the meeting of the EU's environmental goals.[13] The creation of the Taxonomy has required a massive effort[14] Its primary goal is to combat one of the major deficiencies in the market for sustainable financial products – lack of transparency (and the associated risk of greenwashing). Before the creation of the Taxonomy, the guidance as to what could be described as (environmentally) sustainable economic activity in EU law was very limited. This has made it difficult to verify whether a financial instrument or product which claims to be "*green*" (environmentally sustainable) indeed contributes to an environmental goal.[15]

The Taxonomy is the backbone of the fledgling European system of sustainable finance. It tells us which selected types of economic activities can be considered "environmentally sustainable" in the context of EU law ("Taxonomy-aligned"). In order to be considered environmentally sustainable, an activity must (i) significantly contribute to one of the EU's environmental goals, (ii) not cause significant harm to other EU environmental goals, (iii) comply with certain minimum safeguards with respect to social and human rights considerations[16]; and (iv) be in compliance with technical criteria set out by the European Commission in delegated acts.[17] In practice, the technical criteria are of crucial importance.[18]

The Taxonomy aims to be a standard to be used in EU secondary legislation rather than a simple labelling system.[19] As an example, the proposal for a European green bond standard assumes that European green bonds will be Taxonomy-aligned. A green bond is generally defined as an instrument whose proceeds will be used to finance green projects,[20] and the European green bond standard will likely provide that a green project has to be Taxonomy-aligned.[21] Similarly, where an EU-law based financial

[8] *Strategy for Financing the Transition to a Sustainable Economy, op. cit.*

[9] So far only an environmental taxonomy has been enacted by the EU with works having commenced with respect to a social taxonomy, as discussed below.

[10] *Ibidem*, p. 30.

[11] See: Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (COM(2022) 71 final, 2022/0051(COD)), art. 4-8.

[12] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020, p. 13–43).

[13] These goals are described in article 9 of Regulation 2020/852 and include (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) the transition to a circular economy, (v) pollution prevention and control and (vi) protection and restoration of biodiversity and ecosystems.

[14] The Commission has called for a creation of taxonomy regulation in its 2018 Action Plan while Regulation 2020/852 will not be fully operational until 2023.

[15] See e.g. *Action Plan: Financing Sustainable Growth…, op. cit*.

[16] We have detailed below that the minimum safeguards rule included in Regulation 2020/852, which concerns social issues, is of limited usability.

[17] For a discussion of how to apply Taxonomy see e.g. D. Nevzat, *EU Sustainable Finance Taxonomy, Journal of International Banking and Financial Law* (2021) 7 JIBFL 506.

[18] The so called „Climate Delegated Act" relating to two environmental objectives of the Taxonomy (climate change mitigation and climate change adaption entered into force on 1 January 2022, see: Commission Delegated Regulation (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives (OJ L 442, 9.12.2021, p. 1–349).

[19] See: Regulation 2020/852, motive (14)-(16).

[20] See: Green Bond Principles Voluntary Process Guidelines for Issuing Green Bonds (ICMA, June 2021), p. 2.

[21] See: Proposal for a Regulation of the European Parliament and of the Council on European green bonds (COM/2021/391 final), art. 4.

(investment) product has an environment-related ESG element, it should be benchmarked against the Taxonomy.[22] The Taxonomy is also to be used for purposes of non-financial environmental reporting.[23] The above examples are only preliminary use-cases for the Taxonomy – it should be expected that in the future it will be used more and more often in order to assess the performance of various economic activities against the EU's strategic environmental goals.

The minimum safeguards rule described in article 18 of Regulation 2020/852 is particularly interesting because it introduces a social element to an instrument whose objectives are environmental. It requires environmentally sustainable economic activities to be aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights[24] so that they do not violate any important social considerations while achieving one of the EU's environmental goals. This rule lacks any concrete regulatory guidance.

In October 2022, the Platform on Sustainable Finance published a report which recommended that the minimum safeguards rule focus mainly on the following social considerations: (1) human rights; (2) bribery, bribe solicitation and extortion; (3) taxation; and (4) fair competition. However, the report highlights that there is still a significant degree of confusion as regards compliance with the minimum safeguards rule and that even ESG rating agencies have different approaches when evaluating compliance.[25] Consequently, the Platform proposed detailed compliance rules for different social issues. With respect to human rights in particular the Platform recommends that undertakings first implement adequate human rights due diligence procedures, as outlined in the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, and then monitor compliance with those procedures. Conversely, an undertaking would be deemed to be non-compliant with the minimum safeguards requirement in respect of human rights if (i) it has not established adequate due diligence procedures; or (ii) it has been found in breach of its human rights obligations.[26] In practice, forthcoming legislation relating to corporate reporting obligations discussed below will most likely include changes to social reporting obligations, which should facilitate monitoring of compliance with the minimum safeguards rule.

4. Corporate reporting obligations

In 2014, the EU introduced a non-financial reporting directive (the "NFRD Directive") which obliged selected (large) corporate entities (including, but not limited to, certain financial institutions) publishing non-financial statements to report on significant ESG considerations relating to their business.[27] There is also a new legislative proposal in the works which proposes significant changes to the system of EU ESG reporting. It proposes, inter alia, enlargement of the subset of entities obliged to perform ESG-related disclosures, an increase in the amount of information to be published in accordance with the concept of double materiality described above, and the standardization of disclosures in order to ensure their comparability and mandatory audit of disclosures.[28]

5. Prudential regulations

In the area of prudential regulation, supervised entities in the banking, capital markets and insurance sector are being asked to consider ESG risks in their dealings. For banking institutions and investment firms falling within the scope of the Credit Requirements Directive and the Capital Requirements Regulation (CRR/CRD) regulatory regime, the new article 449a of Regulation CRR requires selected large institutions to disclose how they consider ESG risks in their business.[29] There is also a proposed legislative change to the CRR/CRD package currently being considered by the Council and the Parliament. According to the proposed new article 87a of the CRD Directive, supervised entities within the CRR/CRD regime would have to take into account ESG risks, to be measured in different scenarios and time horizons.[30] In the insurance sector, within the Solvency II regulatory regime, changes already implemented to the Delegated Directive 2015/35 have the supervised entities take into consideration the impact of sustainability risks on their business.[31] Similar obligations have been imposed on investment firms supervised within the MiFID II regulatory regime.[32]

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[22] See: Regulation 2020/852, art. 5 and 6.

[23] *Ibidem*, art. 8.

[24] Regulation 2020/852, art.18.

[25] See: Final Report on Minimum Safeguards, Platform for Sustainable Finance, October 2022, https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-minimum-safeguards_en.pdf (access: 4 Oct 2022).

[26] *Ibidem*, page 34, 63. The report is not a binding document – it may or may not be considered by the Commission in further legislative actions.

[27] See: Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (*OJ L 330, 15.11.2014, p. 1–9*), added art. 19a. to the Directive 2013/34.

[28] See: Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (COM(2021) 189 final, 2021/0104(COD)). The Directive is expected to be adopted in November 2022, with changes introduced to the original proposal which do not substantially alter the elements highlighted in the text.

[29] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (*OJ L 176, 27.6.2013, p. 1–337*), new art. 449a.

[30] See: Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU (COM/2021/663 final), proposal for art. 87a.

[31] Supervised entities also have to consider sustainability factors while applying the "prudent investor" rule. See: Commission Delegated Regulation (EU) 2021/1256 of 21 April 2021 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings (*OJ L 277, 2.8.2021, p. 14–17*).

[32] See: Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms (OJ L 277, 2.8.2021, p. 1–5).

6. Facilitating ESG investments

Finally, the fledgling EU regime encourages investor demand for products with ESG considerations and includes a number of initiatives aimed at ensuring that providers of financial products and services offer credible options to invest in sustainable solutions. First, providers of financial products are asked to review and consider any goals of their clients and potential clients relating to sustainability.[33] Second, investment advisors will be asked to consider the wider sustainability preferences of their clients and are explicitly asked to consider potential conflicts of interests relating to such preferences.[34] Third, Regulation 2019/2088 (the "Sustainable Finance Disclosure Regulation") requires selected financial advisers and entities which offer investment products to investors to make general disclosures about the inclusion of ESG considerations in their strategies, their impact on ESG factors and the way in which they take into account sustainability-related risks.[35] The Sustainable Finance Disclosure Regulation also sets out detailed disclosure and reporting obligations for individual financial products that promote environmental or social characteristics or have sustainable investments as their objectives.[36] Fourth, as indicated above, there is also a legislative proposal for a EU green bond standard, which should be Taxonomy- aligned and provide for standardized reporting and verification obligations for the issuers. Finally, the EU's scheme for regulating indices used as benchmarks in financial instruments and financial contracts ("benchmarks") has been expanded to include climate transition benchmarks, meaning benchmarks that purport to measure the performance of a portfolio of assets consistent with the EU's decarbonization goals.[37]

7. Focus on environment – the "how"

Upon closer examination of the EU sustainable finance framework, it becomes clear that the regulatory spotlight so far has been on the "E" factor. First, there are regulations which focus solely on environmental considerations. Most notably, the Taxonomy is focused entirely on environmental goals.[38] As will be discussed below, work on a Taxonomy for social considerations has only commenced relatively recently.

That priority has been given to environmental issues is also evident upon examining the other regulations relating to sustainable finance. As we have shown above, on a general level, an increasing number of institutions are being asked to consider ESG matters in the context of corporate reporting, prudential regulation and offerings of financial products and investment advice. In each case there is increasing guidance on what should be done with respect to *environmental and climate* factors (and associated risks) but little direction when it comes to social factors.

For example, in the context of disclosures, the Taxonomy has attempted to improve the quality of non-financial reporting on environmental factors and risks. Article 8 of the Regulation 2020/852 describes new obligations for entities obliged to publish non-financial information pursuant to the NFRD Directive. Such entities, with respect to the environmental aspect of their non-financial reporting, are obliged to report on their alignment with the Taxonomy – beginning in 2023 for non-financial entities and in 2024 for financial institutions.[39] Similarly, recently published regulatory technical standards to the 2019/2088 Regulation assume that financial products which have sustainable investments as their objective or which promote environmental or social characteristics may refer to the Taxonomy with respect to their environmental impact. No comparable benchmarks are given for social objectives in either case.[40]

In the banking sector, the proposed changes to the CRR/CRD package assume that the incorporation of sustainability risks into the business models of the supervised entities will commence with climate risks.[41] While, as described above, the new article 449a of the CRR Regulation requires selected financial institutions to publish periodic reports on ESG risks, it explicitly singles out physical and transition risks, which constitute part of the broader category of environmental risk. There is also more detailed regulatory guidance on reporting based on this provision with respect to environmental and climate considerations.[42] Similarly in the insurance sector, proposed changes

[33] See: Commission Delegated Regulation 2021/1257, art. 1; Commission Delegated Regulation (EU) 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations (OJ L 277, 2.8.2021, p. 137–140), art. 1.

[34] See: Commission Delegated Regulation 2021/1257, art. 2; Commission Delegated Regulation 2021/1253, art. 1.

[35] See: Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 20219 on sustainability-related disclosures in the financial services sector (OJ L 198, 22.6.2020, p. 13–43), art. 3, 4 and 5.

[36] See: Regulation 2019/2088, art. 8 and 9.

[37] See: Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (OJ L 317, 9.12.2019, p. 17–27), art. 1.

[38] We have already shown above that the minimum safeguards included in Regulation 2020/852, which concerns social issues, is of limited usability.

[39] See: Commission Delegated Regulation (EU) 2021/2178 of 6 July 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation (the act contains also detailed templates for reporting).

[40] However there are guidelines on how to disclose adverse impact on social factors, see: Commission Delegated Regulation (EU) of 6.4.2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of 'do no significant harm', specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic report (C(2022) 1931 final), Annex 1, Table 3 and Annex 2

[41] See: Proposal for a of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU (COM/2021/663 final), proposal for new art. 87a.

[42] See: EBA, Final draft implementing technical standards on prudential disclosures on ESG risks in accordance with Article 449a CRR, (EBA/ITS/2022/01) EBA, 2022), p. 15-24.

to the Solvency II Directive assume that insurers and reinsurers will have to utilize long-term scenario-analysis with respect to climate risks, but no guidance has been given with respect to other ESG considerations.[43]

The EU's financial sector regulators have affirmed this environmental focus. For example, the European Banking Authority ("EBA"), in its report on management and supervision of ESG risks for credit institutions and investment firms, highlights that, although the supervised entities should consider ESG risks generally, their focus should be on environmental risks.[44] Similar conclusions have been drawn by the European Insurance and Occupational Pensions Authority for the insurance market and European Securities and Markets Authority for the capital market.[45] The significance of climate risk in particular has been underscored by the European Central Bank, which issued a detailed regulatory guide for institutions remaining within the scope of its supervisory competences outlining how they should consider climate risks.[46]

8. Focus on environment – the "why"

That the EU focuses on the environment within broader sustainable finance regulation is of course due to the fact that issues relating to the deterioration of the environment and climate change in particular have become significantly more prominent on the global agenda in recent years.

Combating climate change is a global objective. There is a widespread scientific consensus that unless effective action is undertaken to curb the emissions of greenhouses gases, human society will not be able to limit the rise of air temperatures well below 2°C compared to pre-industrial levels, in which case severe negative consequences will most likely occur.[47] The goal of limiting greenhouse gas emissions and temperature growth is included in the 2015 Paris Agreement, signed so far by 194 parties.[48] Since 1995, the UN has organised an annual Conference of Parties (generally known as CoP), so that the signatories to the United Nations Framework Convention on Climate Change can monitor their progress and decide on the appropriate measures and policies to be taken to fight climate change.[49]

The European Union has published important strategic documents presenting an ambitious environmental and climate policy, most importantly the *European Green Deal*.[50] In 2021, the European Climate Law enshrined the EU's environmental objectives (to limit its greenhouse gas emissions by 55% by 2030, compared to 1990 levels and to become climate-neutral until 2050) in a binding secondary law.[51]

Within the financial system, there is broad regulatory consensus that environmental and climate risks are systemic in nature and historically have not been adequately considered by financial institutions.[52] Due to progressing climate changes, negative events may occur in the environment and expose companies to *physical* environmental and climate risks. Moreover, the increasing effort to transition the European economy to a low-emission model creates *transition* risks for polluters and financiers exposed to high-emission assets.[53] In the wake of the 2007-2008 financial crisis, the attention of European regulators has been on the identification and mitigation of systemic risks. Against this backdrop it is understandable why prudential regulations have focused on identifying, managing and mitigating systemic risks related to climate change.

For all these reasons it should come as no surprise that the main focus of legislative and regulatory interventions has been on environmental and climate considerations. The priority given to environmental considerations may also be explained by reference to the "*wedding cake model*" developed by the Stockholm Resilience Center[54] based on the SDGs[55]. This model suggests that environmental goals represents the foundation of sustainable development, upon which other ESG goals may be reached.

9. Social considerations in the European Union

While social considerations have not carried the same weight as environmental ones in the EU's sustainable finance framework, attempts to incorporate social considerations in more detail have intensified in recent years. We believe that this is due to the reasons we indicate below.

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[43] See: Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision (COM/2021/581 final), proposal for new art. 54a.

[44] See: *EBA Report on management and supervision of ESG risks for credit institutions and investment firms* (EBA/REP/2021/18), p. 34.

[45] See e.g. Opinion on the supervision of the use of climate change risk scenarios in ORSA, (EIOPA-BoS-21-127), Opinion on Sustainability within Solvency II, (EIOPA-BoS-19/241) or ESMA's *Strategy on Sustainable Finance* (2020).

[46] ECB, *Guide on climate-related and environmental risks - Supervisory expectations relating to risk management and disclosure* (2020).

[47] See e.g. the leading IPCC report on this issues: *Climate Change 2022: Impacts, Adaptation, and Vulnerability*. *Contribution of Working Group II to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change*, H.-O. Pörtner, D.C. Roberts, M. Tignor, E.S. Poloczanska, K. Mintenbeck, A. Alegría, M. Craig, S. Langsdorf, S. Löschke, V. Möller, A. Okem, B. Rama (ed.), Cambridge University Press, 2022.

[48] See: Article 2 of the Paris Agreement.

[49] The most recent such convention (CoP26) was held in Glasgow in November 2021. Participant states adopted decisions to strengthen their efforts to build resilience to climate change, to curb greenhouse gas emissions and to provide the necessary financing for these objectives.

[50] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, The European Green Deal (COM/2019/640 final).

[51] See: Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law') (OJ L 243, 9.7.2021), p. 1–17, art.2 and 4.

[52] See e.g. *Guide on climate-related and environmental risks… op. cit*, p. 14.

[53] See e.g.: *EBA Report on management and supervision of ESG risks… (op. cit.)*, p. 54.

[54] The model is available on https://www.stockholmresilience.org/research/research-news/2016-06-14-the-sdgs-wedding-cake.html (access: 4 Oct 2022).

[55] The Sustainable Development Goals developed by the United Nations, available at https://sdgs.un.org/goals (access: 16 November 2022)

To begin, there are moral and conceptual reasons why social considerations cannot be ignored. The broader theory of sustainable development generally assumes the balancing of E, S and G factors (so that none of these factors are ignored).[56] Accordingly, social considerations play an important part within the SDGs, which the EU aims to realize as part of its international law obligations, as well as documents such as the European Pillar of Social Rights.[57]

Market forces also explain the interest in social considerations. European citizens view social issues (poverty, hunger, lack of proper infrastructure and lack of drinking water) as the second most important category of problems in the world, after climate change.[58] While the market for socially sustainable financial instruments is not yet as large as the market for environmentally sustainable ("green") instruments, it has been growing very rapidly in the past years.[59] At the beginning of 2021, the Loan Market Association (LMA), together with Asia Pacific Loan Market Association and Loan Syndications & Trading Association, issued the Social Loan Principles (SLPs): a market standard for socially sustainable loans, building upon the Social Bond Principles published by International Capital Markets Association (ICMA).[60] As the market for social finance expands, regulation becomes more important, just as it did for green finance.

10. The European social taxonomy

As described above, social considerations are already present in EU sustainable finance law, despite the fact that regulatory attention has focused on environment and climate so far. The process of including social considerations in the European sustainable finance framework in greater detail has commenced with an attempt to create a taxonomy of socially-sustainable activities.[61]

A final report on social taxonomy was published by the Platform for Sustainable Finance in February 2022. The Platform recommends that an economic activity should be deemed economically sustainable if it (i) contributes to one of the proposed social objectives; (ii) causes no significant harm to other social objectives; and (iii) is in line with the minimum safeguards rule. The following social objectives have so far been suggested: (i) decent work (including value-chain workers); (ii) adequate living standards and wellbeing for end-users; and (iii) inclusive and sustainable communities and societies. It is also envisaged that detailed screening criteria will be developed for socially sustainable activities.[62]

While the work on social taxonomy is still at an early stage, the Platform for Sustainable Finance has already recognized that such a taxonomy will have to differ in many ways from the (environmental) Taxonomy. First, the social taxonomy is likely to be more granular: the report identifies detailed sub-objectives for each of the three proposed social objectives listed above and proposes that the assessment of whether an activity substantially contributes to a social goal and does no significant harm to other social goals be conducted at the level of those sub-objectives.[63] Second, whether an activity substantially contributes to the realization of a social (sub)objective may need to be measured differently than for environmental objectives. For example, contributing to a social objective may often have at its core *abstaining* from doing something (e.g. prevention of child labour) rather than some *positive* action.[64] Third, the social taxonomy will define the interaction between social and environmental considerations in the course of determining how its minimum safeguards component should be structured and construed.[65]

11. Social considerations – do they pose a risk?

According to a survey conducted by the Platform for Sustainable Finance, the proposal for a social taxonomy has enjoyed a generally positive response, with 78% of market participants surveyed being in favour of the idea.[66]

However, the need for a social taxonomy is still under debate. Even within the Sub-group on the social taxonomy within the Platform on Sustainable Finance, there are differences of opinion on whether such social taxonomy is necessary.[67]

On the one hand, in the absence of a social taxonomy issuers have significant freedom in declaring what activities (and financial products) are socially sustainable. This may lead to *socialwashing*, i.e. to situations where a claim is made that a financial instrument (and the underlying economic activity) contributes to the realization of a social objective,

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[56] See e.g. D. Schoenmaker, W. Schramade, *Principles of Sustainable Finance*, Oxford 2019.

[57] See: The European Pillar of Social Rights proclaimed by the European Parliament, the Council and the Commission in 2017, https://ec.europa.eu/info/sites/default/files/social-summit-european-pillar-social-rights-booklet_en.pdf (access: 4 Oct 2022).

[58] Source: Special Eurobarometer 513: *Climate Change Report (Fieldwork: March - April 2021)*, p. 9.

[59] Cource: Data of the Climate Bonds Initiative: https://www.climatebonds.net/files/files/2015%20GB%20Market%20Roundup%2003A.pdf (access: 4 Oct. 2022).

[60] See: Social Loan Principles (2021), available at: https://www.lsta.org/content/social-loan-principles-slp/ (access: 4 Oct. 2022).

[61] *Strategy for Financing the Transition to a Sustainable Economy. . . op. cit.*

[62] See: *Final Report on Social Taxonomy* (Platform on Sustainable Finance, February 2022), p. 13.

[63] *Ibidem*, p. 29.

[64] In the draft report from July 2021 these differences were described as the horizontal and vertical dimensions of social taxonomy, see e.g. O. Heiland, H. Glander, *ESG integration and Social Taxonomy developments in the EU Sustainable Finance Framework*, Journal of International Banking and Financial Law (2021) 8 JIBFL 568.

[65] *Final Report on Social Taxonomy. . . op. cit*, p. 29-45.

[66] *Ibidem*, p. 14.

[67] See: *Draft Report by Subgroup 4: Social Taxonomy* (Platform on Sustainable Finance, July 2021) (s. 1.1, p. 6).

where in reality it does not. This could negatively affect the stability of and trust in the European system of sustainable finance, as well as the European financial system in general.

On the other hand, critics have argued that adoption of a social taxonomy is unnecessary and may in fact hinder the development of sustainable finance in the EU.[68] This argument is based in part on the fact that it remains to be seen whether a social taxonomy can effectively reduce the risk of *socialwashing*. In addition, social sustainability is more difficult to define and measure than environmental sustainability and there are fears that creating a detailed glossary of socially sustainable economic activities will involve a substantial administrative burden. Taxonomies in general have been criticized in literature as being backwards-looking, rigid and inflexible, these criticisms may have particular force in relation to social considerations.[69]

In any case, if the development of the (environmental) Taxonomy offers any guidance, it will be years before a social taxonomy is operational.[70] Hopefully, if and when the social taxonomy is developed, the EU should already be able to draw lessons from the implementation of its environmental regulations, including the Taxonomy.

The alternative to a taxonomy would be a more principle-based approach, similar to ones employed by international financial institutions. This would entail regulating social finance based on a system of more general guidelines rather than a detailed classification and benchmarking of selected economic activities. In the context of the EU's financial markets as a whole, a principle-based approach could be difficult to implement, especially given the need to ensure effective supervision in each of the EU member states). However, it has to be noted that, following the publication of the final report on social taxonomy by the Platform on Sustainable Finance discussed above, there has not been much impetus to move forward with the legislative proposal on the subject, with some sources citing political considerations as the underlying reason.[71] It remains to be seen how the situation develops.

12. Points to consider for legal practitioners in international financial institutions

There are many reasons why legal practitioners in international financial institutions should follow developments in the field of sustainable finance in the EU. First, as we have outlined above, the European system of sustainable finance is being created based around taxonomies – i.e. systems of classification of economic activities based on ESG factors. The goal is to provide clarity and comparability between different disclosures and financial products and to reduce the risk of greenwashing and socialwashing, keeping in mind the interests of the ultimate investors. Legal practitioners in international financial institutions should observe whether this taxonomical approach proves successful. If yes, they could consider employing it in their own sustainable finance policies. Additionally, EU-based financial institutions in particular may request to utilize taxonomies in the future, which may impact syndicated deals.

Second, EU sustainable finance regulation aims to contribute to the achievement of concrete strategic outcomes by defining sustainable economic activities with reference to EU policy goals. Observing whether the European exercise is successful may provide important lessons on whether such an "activist" regulatory approach can be successful.

Third, as we have indicated, a lot of work is being done in the EU in the area of reporting and information gathering on the one hand, and in prudential regulation on the other. The EU aims to make ESG disclosures more meaningful, verifiable and comparable, and plans to employ specialized third-party verifiers to that end.[72] In the area of prudential regulation, detailed analysis of ESG risks is being demanded from European financial institutions. International financial institutions may be able to draw on the information produced in response to these requirements in connection with the projects they finance and their portfolio companies.

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[68] Source: https://www.svensktnaringsliv.se/english/social-taxonomy-no-thank-you_1173867.html (access: 4 Oct 2022).

[69] See e.g., Steuer, T. Tröger, *The Role of Disclosure in Green Finance*, Journal of Financial Regulation, 2022, 8, s. 1–50.

[70] As we indicated above, around 5 years will have passed before the commencement of works on the environmental Taxonomy and its full implementation.

[71] See e.g. an article by E. Meager on the subject: https://capitalmonitor.ai/regions/europe/why-social-taxonomy-no-longer-eu-priority/ (access: 4 Oct. 2022).

[72] See: Proposal for a Regulation of the European Parliament and of the Council on European green bonds, *op. cit.*, Title III.

A Further Step Towards Harmonisation – **DFI Cooperation in Private Equity Fund Investments**

James Wilson[1]

Abstract: The European Bank for Reconstruction and Development (EBRD) has recently participated with other Development Finance Institutions (DFIs) and International Financial Institutions (IFIs) in the revision of a key document that is used by DFIs and IFIs when they invest in Private Equity (PE) funds, the **DFI Funds Matrix** ("Matrix"). This paper will describe the role of the Matrix in DFI Fund investing and some of the challenges and experiences of DFI investors that led to the revision of the Matrix. It will highlight twelve of the most important changes that were made to the Matrix in order to mitigate new or increasing risks for PE fund investors and to implement new best practice and governance arrangements.

Finally, this article will also explain how revising the Matrix is only one step in the overall aim of harmonising and streamlining DFI and IFI investments in PE funds, there being many ongoing and future plans to make further progress to allow DFIs and IFIs to have an even greater impact in this area.

1. Background

In 2012, the European DFIs and IFIs that were active in private equity fund investments established the DFI Cooperation Project. The aim of this Project was to develop a coordinated and streamlined approach to DFI investments in private equity funds. The project focussed on achieving efficiencies and impact by creating the basis for a common DFI approach on (i) economic and legal requirements, (ii) due diligence and information sharing, and (iii) policy requirements (ESG, AML/CFT, KYC and integrity). A group of internal counsel within the DFIs (the "**DFI Funds Counsel Group**") was also established to provide a focal point for lawyers within those DFIs, to share ideas about harmonising, streamlining and coordinating the DFI investors' private equity investments, especially those PE fund investments that were expressed to be under the DFI Cooperation Project.

1.1. The DFI Cooperation Project in Action

In 2013, EBRD and many other DFIs and IFIs completed an investment in a private equity fund focused on North Africa, which was an excellent example of the DFI Cooperation Project in action. All initial due diligence – including challenging the pipeline, and setting the size and budget of the Fund – was conducted by all the DFIs together; they also contributed to the selection of a joint DFI counsel. Given the presence of so many DFIs and IFIs, the negotiations of the legal documentation were focussed on reaching close alignment between the DFI investors first before discussing terms with the Manager.

1.2. The DFI Funds Matrix

DFIs achieved harmonised legal documentation using a DFI Funds Matrix (the "**Matrix**"), which set out the collective DFI views on the key legal and commercial terms to promote good corporate governance and reflect best practice. The Matrix was then used by DFI Fund counsel to prepare or review the first drafts of the Fund documentation and on an ongoing basis as a benchmark to ensure that all DFIs agreed on any material deviations to the Matrix terms.

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Since the early days of the Matrix, it has been used widely (and adapted by individual DFIs and IFIs for their own use), but there has not been a further official revision of the Matrix by a group attempting to act for all DFIs until quite recently. This despite the fact that there have been a number of important developments in PE funds active in the emerging markets of the DFIs' respective regions in the meantime.

2. Why was the Matrix revised?

As well as seeking to harmonise DFI fund terms generally, the DFI Funds Counsel group has prioritized at least three specific PE fund issues or themes since 2012:

i) *End of life issues* – most DFIs and IFIs have mature fund portfolios with many funds requiring term extensions, with the potential for zombie funds because the fund manager has little remaining incentive to exit and wind up its portfolio. The DFI Fund Counsel group has had a number of training sessions covering fund end of life issues.

ii) *Liquidity issues* – a feature of most DFI fund investments is that they are illiquid; there is a limited secondary market, and all early exits by an investor from a fund investment generally require a cooperative fund manager. The DFI Funds Counsel Group has had discussions and trainings on General Partner (GP) led restructurings and has looked at the benefits of permanent capital vehicles.

iii) *Investor misalignment through complicated fund structures and individual investor vehicles* – For many DFI investors, the domiciliation of funds and their parallel and related partnerships/managed accounts, the erosion of Most Favoured Nation protections, the limited visibility of other investors' rights against the fund manager or fund, and their conflicting interests have become an increasing issue.

2.1. Abraaj was the catalyst for the DFIs changing the Matrix

However, there was another important event that pushed the DFIs and IFIs to revise the 2012 Matrix.

Many DFIs and IFIs were also invested in funds managed by Abraaj, which was, in 2018, the largest private equity firm dedicated to emerging markets. The collapse of Abraaj in late 2018 became the world's largest private equity insolvency and was institutionally demanding for many of the DFIs and IFIs who were invested in the Abraaj funds. This period created a further dimension to the DFI Cooperation Project as those DFI and IFI investors in Abraaj funds worked intensively together sharing counsel and exercising rights through the Investor Advisory Committees ("LPACs") of the various funds.

2.2. What happened with the Abraaj funds?

Abraaj's ultimate holding company ("AHL") and the top management company ("AIML") of all the Abraaj GP and manager entities incurred high levels of debt for non-fund related activities. AHL and AIML then secured their GP shares, carried interest and/or GP LP interests in the various Abraaj funds in favour of their creditors. In addition, the carried interest entitlements of the Abraaj fund Key Persons and their teams were often never properly formalised in the fund documentation.

The Abraaj collapse and the placing of those two top Abraaj companies in provisional liquidation then meant that the Abraaj Joint Provisional Liquidators ("JPLs") gained a measure of control over the Abraaj funds themselves. Thereafter, the Abraaj fund investors effectively had to engage with the Abraaj JPLs who owed their primary duties to the Abraaj secured and unsecured creditors instead of with the Abraaj Key Persons whom they had chosen under the fund documentation to manage their fund commitments. At the same time, the DFI and other fund investors also had to deal with issues such as liquidation costs being charged as fund expenses and management fees continued being payable to the JPLs.

After the management of the majority of the Abraaj funds had been normalised by late 2019, the DFI Funds Counsel Steering Group decided to revise the Matrix for the benefit of all DFIs in light of the Abraaj experience, the latest developments in ILPA and best practice, particularly in respect of the three PE fund issues outlined above. In October 2020, the Steering Group held an online session for all DFI Funds Counsel members to present the key revisions to the Matrix – and the background and reasons for the changes.

The new 2020 Matrix contains various suggested improvements in corporate governance and best practice to align all DFI investors with mutually acceptable fund terms. Assuming these terms are consistently demanded and expected by all investing DFIs, this should make the DFI Fund documentation more straightforward, easy to negotiate and, of course, also lead to the IFIs and DFIs (and other investors) being better protected in their private equity fund investment documentation.

3. Twelve examples of revisions included in the Matrix 2020

To provide a better picture of the revisions to the 2012 Matrix, I will now summarise twelve of the most important changes that were made to the Matrix in order to mitigate the new, or more serious, fund issues or risks now faced by PE fund investors, particularly in emerging markets.

3.1. Prevent third party interference with the fund's economics.

It should be a principle that investors' capital is being managed only by the chosen fund manager and its investment team. The fund documentation should (a) expressly prohibit any fund manager interests from being pledged or

secured in favour of creditors; and (b) make sure that the Key Persons and management team are properly aligned by maintaining the GP commitment and by formalising 100% of the carried interest allocations prior to first closing of the fund. Investor consent should be required for the creation of any security over the Manager's capital commitment, carry or GP interest; the GP commitment should be maintained for the life of the fund.

3.2. Tighten up the Key Persons provisions.

In particular, make sure investors have rights and remedies even if there is a Key Person Event after the end of the Investment Period.

3.3. Make sure that investors cover all important governance matters in the reporting package and can investigate and act if there are suspected Manager breaches.

The Manager should report regularly on all key fund matters including the leverage of the fund, carried interest calculations, provision of structure charts (ownership structure) and the Manager's commitment. The Manager should give investors and the LPAC full access and inspection rights of the fund management entities and the portfolio companies, and the right to appoint a third party auditor.

3.4. Empower LPAC with a full suite of powers to represent investors in stressed situations.

For example, it should be able to appoint outside counsel for the LPAC and charge investors by making it a fund expense.

3.5. Empower LPAC to review and approve all related party transactions as a conflict.

It should be assumed that all related party contracts give rise to conflicts that need to be approved by the LPAC.

3.6. Recognise the importance and power of the portfolio companies in the fund portfolio.

If investors are seeking a new manager for the fund, whether due to cause or no cause, then the opinions of the management and other shareholders of the fund's key portfolio companies on potential new managers will always be relevant. However, the fund documentation should always make it clear that the fund manager's investments in portfolio companies must not be structured with "poison pills" that block a fund manager's replacement or force an indirect sale of the portfolio company with a discount. Similarly, if investors have lost confidence in the fund's management of any portfolio company then it is also important that investors can obtain access directly to the fund's portfolio companies on request.

3.7. Use capital call requirements for extra governance.

The information and confirmations required in capital calls have increased. This was one area where investors had some leverage against the JPLs as the existing capital call requirements in the Abraaj fund documentation were already prescriptive. For example, capital calls were only recognised by investors if issued by authorised signatories of the GP. There are new standard information requirements on capital calls, including an obligation on the GP to issue a capital call (with all the required information included therein) even if there is a recycling of proceeds after an exit and there is no fresh capital being drawn from investors.

3.8. Ensure the Manager reacts appropriately and in a timely manner to all investor defaults.

Investor defaults that had not been acted on or followed up by the Manager were a feature of the Abraaj funds. There is now an obligation of the GP in the Matrix to notify all investors of any investor defaults immediately if the default continues after a reasonable cure period.

3.9. Limit the circumstances wherein a fund can borrow.

In particular, it is now noted in the Matrix that DFIs have important restrictions about how security can be enforced. Commitments must be drawn down in the name and to the account of the fund or the manager only (not by lenders).

3.10. Apply changes of control rights to all the GP group.

Specific change of control provisions should be added for each of the Manager, the GP and the Carry Vehicle. These rights should ultimately allow the investors to remove the Manager for cause if breached.

3.11. Ensure that the fund indemnity does not work against the investors.

The Fund's indemnity provision should not allow Key Persons to fund cause litigation against the investors or between GP fund vehicles. The provision should make it clear that there is no waiver or dilution of the Manager's fiduciary duties.

3.12. Prevent confidentiality obligations in the fund documentation from impeding investors from exercising remedies.

The duties of confidentiality owed by investors to the fund should still allow investors to (i) share information with other investors (as necessary to enforce their rights under the fund documents) and to (ii) pass on fund information to a potential replacement manager provided that appropriate confidentiality undertakings have been obtained from such potential replacement managers.

4. What lies ahead?

For the institutions that are members of the Steering Group, the exercise of revising the Matrix was beneficial in itself, as it involved extensive cooperation and discussions during the COVID pandemic on complex legal issues in PE funds documentation. However, the new Matrix produced in late 2020 is certainly not the end of the story. It is a living document and the Steering Group will be considering further changes to reflect new experiences and developments in the sector.

At the full DFI Counsel Group meeting in March 2022, it was announced that the Steering Group has instructed counsel to prepare new DFI model fund documentation that is based on the revised Matrix. This is expected to be released to the full DFI counsel Group in the second half of 2022. In the meantime, the sector remains very dynamic and there have also been further recent market developments, such as recent high profile emerging markets fund restructurings, that will likely lead the Steering Group to revisit certain of the 2020 Matrix provisions further in the short term.

4.1. Further information

If any reader wishes to receive a copy of the latest DFI Funds Matrix 2020 or to register themselves or their institution to join the DFI Funds Counsel Group, please contact the author at wilsonj@ebrd.com.

Legal Framework Applicable to European Union funded Grants administrated by **Multilateral Development Banks for Development Projects**

*Taos Aliouat**

Abstract: This article purports to present major developments in the implementation of European Union (EU) funds following the adoption of the 2018 EU Financial Regulations and the 2021-2027 Multiannual Financial Framework (MFF). It will address the contractual implications stemming from the adoption of the above-mentioned regulations from the perspective of the EU relationship with Multilateral Development Banks (MDBs) when the European Commission (EC) implements the EU budget through indirect management. It will also examine project implementation aspects by analysing the main EU specific legal provisions which need to be reflected in grant agreements signed between grant beneficiaries and the MDBs channelling EU bilateral contributions for development projects. This article will focus exclusively on: (i) EU external action and development aid in particular (excluding programmes targeted to EU member states such as InvestEU), and (ii) EU bilateral contributions providing non-reimbursable financing in the form of grants (excluding multi-donor funds such as WBIF, and financial instruments such as guarantees).

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1. Introduction

The European Union financial architecture for external action, including development aid, has been the subject of intense discussions in recent years. The adoption of the 2021-2027 MFF in 2021 marked a turning point.[1] It streamlined a complex array of funding instruments and programmes, some which used to be included in the EU budget and some historically funded by EU member states outside of the EU budget. This consolidation of instruments was made all the more urgent by the COVID pandemic which demonstrated the need for the EU to deal with unexpected challenges through more flexible financial instruments, permitting better coordination among EU actors. The break out of the war in Ukraine could only reassert EU's need for a more speedy and efficient deployment of funds for its external actions.

This article presents the major recent changes in the external action financial architecture of the EU. It focuses mainly on development actions implemented through indirect management following the adoption of the 2021-2027 MFF, and addresses the implications of the adoption of the 2018 EU Financial Regulations[2] (2018 Financial Regulations) both (i) in the relationship between the EU and its partner Multilateral Development Banks (MDBs) and (ii) at the project level when MDBs channel EU funds through grant agreements they sign with grant

[1] Council Regulation (EU, Euratom) No. 2020/2093 of 17 December 2020, laying down the multiannual financial framework for the years 2021-2027.

[2] Regulation (EU, Euratom) No 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EC, Euratom) No 966/2012.

beneficiaries. To that end, section 2 of the article covers the 2021 streamlining of the EU's external action instruments under the new 2021-2027 MFF, culminating with the adoption of the Neighbourhood, Development and International Cooperation Instrument (NDICI)-Global Europe (NDICI-Global Europe) regulation. The latter merges into a single financial instrument most of the previous instruments for cooperation with non-EU member states. Section 3 analyses the implications of the adoption of the 2018 Financial Regulations in the contractual relationship between the EU and MDBs when the EU budget is implemented through indirect management. It presents the new financial framework agreements governing the use of EU bilateral contributions by MDBs. Finally, section 4 of the article highlights the main EU specific legal requirements that need to be reflected in MDB grant agreements signed with grant beneficiaries when such grants are financed by EU bilateral contributions.

2. The 2021 restructuring of the EU financial architecture for external action: a focus on development aid

2.1. The Legal Basis of the EU Development Aid Policy

The EU development aid policy is at the heart of EU's external action, alongside foreign, security, and trade policies. The EU along with its member states (Member States) are the world's largest provider of development aid. Together they provided 46% of public development aid in the world in 2021.[3] As a major player, the EU has significant influence in establishing priorities in the development agenda.

Development cooperation is a shared competence of the EU and its Member States.[4] While Article 4 of the Treaty on the Functioning of the European Union (TFEU) attributes to the EU competence to carry out a common development cooperation policy, EU countries maintain their own competence in this field. Such imbrications require a certain level of cooperation and coordination between the EU and its Member States, especially as Member States' respective national development agencies often implement EU-funded programmes.

EU development policy originated at the beginning of the EU construction, with the creation of the European Development Fund (EDF) in 1958.[5] The long-term objective of the EU development policy, as set out in Article 208 of the TFEU, is ultimately to eradicate poverty. For that purpose, the EU and its Member States are required to comply with their international commitments for development under the cooperation framework with the United Nations (UN) and other international organisations.[6] In this respect, the 2017 New European Consensus on Development of the EU aligns the cooperation objectives of the EU institutions and Members States to the UN 2030 Agenda for Sustainable Development[7] (the "2030 Agenda"), the Addis Ababa Action Agenda on the financing of development[8] and the Paris Agreement on climate change[9] (the "Paris Agreement"), all signed in 2015. Since 2017, EU development action is structured around the five Ps of the 2030 UN agenda (people, planet, prosperity, peace and partnership) with the goal to achieve the 17 Sustainable Development Goals (SDGs).

In 2007, the Lisbon Treaty[10] also provided as an objective for the EU to uphold and promote its values worldwide. The EU values are reflected in the principles guiding EU external action set forth in the Treaty on the European Union (TEU)[11] and include support for democracy, the rule of law, human rights, fundamental freedoms, the principles of equality and solidarity and multilateralism. EU development aid thus abides by these principles and pursues the objectives of EU external action set out in Article 21(2) of the TEU, in particular fostering economic, social and environmental development of developing countries, keeping as underlying priority the eradication of poverty.[12]

As the EU development aid objectives are deeply enshrined in the EU legal framework, EU external action furthering such objectives also receive financing provided under the Multiannual Financial Frameworks.

2.2. EU budget allocations to external action/ development aid under the 2021-2027 Multiannual Financial Framework

The EU finances its policies and interventions mainly through budget expenditure approved jointly by the Council of the European Union and the European Parliament. The allocation of EU resources is established in the multiannual financial framework (MFF) regulation, usually covering a period of seven years. It purports to ensure financial discipline by setting long term expenditure

[3] <– « La politique européenne de développement », 9 Juillet 2021 <https://ue.delegfrance.org/la-politique-europeenne-de-2025>, accessed 31 May 2022.

[4] Treaty on the Functioning of the European Union – Part One- Principles- Title I – Categories and areas of Union competence – Article 4.

[5] « La politique européenne de développement », supra note 3.

[6] Velina Lilyanova, *Understanding EU Financing for External Action* (February 2021), European Parliamentary Research Service, page 2.

[7] The 2030 Agenda for Sustainable Development established 17 Sustainable Development Goals (SDGs) to be achieved by 2030. It was adopted by the 193 UN member states in 2015.

[8] The Addis Ababa Action Agenda agreed by the UN in 2015 sets out a global framework for the financing of development using all financial resources available beyond Official Development Assistance (ODA), mobilizing in particular private sector investment.

[9] The Paris Agreement is a legally binding international treaty on climate change adopted by 196 Parties at the COP 21 in Paris, on 12 December 2015 and entered into force on 4 November 2016.

[10] Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community (2007/C 306/01).

[11] See Article 3(5) and Articles 8 and 21 of the Treaty on the European Union.

[12] – "EU Development Policy", 9 July 2019 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=legissum%3A4333699>, accessed 31 May 2022.

ceilings which the annual EU budget must respect for broad categories of spending called Headings. In this respect, Heading 6 (Neighbourhood and the World) aims at strengthening economic and social impacts in neighbourhood, developing countries and the rest of the world. It consists of the following programmes: (1) External Action (which is comprised of the NDICI-Global Europe instrument – the focus of this article –, Humanitarian Aid, Common Foreign and Security Policy, and Oversees Countries and Territories) as well as (2) Pre-Accession Assistance (Instrument for Pre-Accession or IPA III[13]) for countries preparing accession to the EU.

To facilitate the implementation of various programmes financed under the MFF, the European Commission (EC) together with the European External Action Services (EEAS) prepare a strategy which lays the ground for the formulation of Multiannual Indicative Programmes (MIPs). A MIP is a multi-year plan for each country, region or programme, including priority areas and indicative financial allocations. A mid-term review of the MIPs is carried out half way through the seven-year period of an MFF. The adoption of MIPs (or revised MIPs) is followed by the approval of the respective Annual Action Plans (AAPs) and financing decisions, which include a description of the actions to be financed by the budget on an annual basis, as decided by the committees of each instrument.[14]

The sixth MFF (covering the 2021-2027 period) was adopted on 17 December 2020[15] to provide for an EU long term budget worth 1.074 trillion Euros in 2018 prices and contemplates new EU own resources.[16] It is topped by the Next Generation EU (NGEU) temporary recovery instrument with an amount of 750 billion Euros in 2018 prices.[17]

The financing of development aid by the EU has historically been provided through resources within and outside the EU general budget. The EU allocates about 10% of its general budget to external action.[18] However, the main and oldest financial instrument supporting development assistance in African, Caribbean and Pacific countries, the European Development Fund (EDF), was until recently financed outside of the EU budget by direct contributions from Member States.

Also, before the 2021-2027 MFF, the EU used a number of different funding instruments to support external action, including development cooperation. Each funding instrument was subject to its own regulation and set of rules and procedures. This fragmentation made the administration and implementation of EU funds very complex, especially when coordinated action was sought.

Under the newly adopted MFF, about ten different financing instruments have been merged into a single instrument – the NDICI – Global Europe – to enhance rapidity, flexibility, visibility and accountability of EU interventions.

2.3. Streamlining the EU Financial Instruments for External Action/Development Aid with NDICI-Global Europe

With the adoption by the Council of the European Union and the European Parliament of Regulation (EU) 2021/947 establishing the Neighbourhood, Development and International Cooperation Instrument (NDICI)-Global Europe (NDICI-Global Europe)[19], the EU now has a principal instrument governing the funding of EU external action. The NDICI-Global Europe regulation establishes the objectives, political framework and expenditure targets as well as general principles of programmation and implementation of the corresponding EU budgeted funds. The new instrument covers cooperation with all non-Member State countries, with the exception of countries which are in a pre-accession process to integrate the EU.[20]

NDICI-Global Europe is structured around three main pillars allowing for flexibility between them: (i) a geographical instrument (covering programmes for sub-Saharan Africa, the EU Neighbourhood, Asia and the Pacific, the Americas and the Caribbean), which includes a unified external investment framework consisting of the European Fund for Sustainable Development Plus (EFSD+) and the External Action Guarantee (EAG),[21] (ii) a thematic instrument (encompassing human rights and democracy, civil society organisations, peace, stability and conflict prevention in addition to global challenges); and (iii) a rapid response pillar. To enhance the flexibility of the instrument, it is complemented by a 'cushion' to

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13 Regulation (EU) 2021/1529 of The European Parliament and of The Council of 15 September 2021 establishing the Instrument for Pre-Accession assistance (IPA III).

14 Katja Sergejeff, Ennatu Domingo and Alexei Jones, *Catching up with Global Europe: 15 Questions on the EU's new Financial Instrument Answered* (February 2022), European Center for Development Policy Management, Briefing Note No.144 at 5.

15 Supra note 1.

16 Interinstitutional Agreement of 16 December 2020 between the European Parliament, the Council of the European Union, and the European Commission on budgetary discipline, on cooperation in budgetary matters and on sound financial management, as well as on new own resources, including the roadmap towards the introduction of new own resources. (OJ L 433 I, 22.12.2020, p.28).

17 Council Regulation (EU) 2020/2094 of 14 December 2020 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis (OJ L 433 I, 22.12.2020, p.23).

18 See ––<https://ec.europa.eu/international-partnerships/funding_en> (Official website of the European Commission), accessed 31 May 2022.

19 Regulation (EU) 2021/947 of The European Parliament and of the Council of 9 June 2021 establishing the Neighbourhood, Development and International Cooperation Instrument – Global Europe, amending and repealing Decision No 466/2014/EU and repealing Regulation (EU) 2017/1601 and Council Regulation (EC, Euratom) No 480/2009 (OJ L209, 16.6.2021, pp.1/78). Regulation (EU) 2021/947 was supplemented by Commission Delegate Regulation (EU) 2021/1530 of 12 July 2021.

20 More precisely, the geographic programmes of NDICI- Global Europe (the largest share of the instrument's envelope) exclude IPA III countries and overseas countries and territories (Greenland and the Kingdom of Denmark). However, the thematic programmes and the rapid response pillar cover all third countries (non-EU Member States) as well as overseas countries and territories.

21 The new investment framework also covers IPA III countries. It builds on the 2017 EU External Investment Plan (EIP) and aims to mobilize additional funds from the public and private sector to support sustainable investment worldwide. EFSD+ purports to operate as a single blending facility with a worldwide coverage for any pillar assessed development institution seeking EU funding. Similarly, EAG is an open guarantee framework merging several guarantee instruments of the EU.

finance emerging challenges and priorities (such as responses to unforeseen circumstances, crisis/post-crisis situations, migratory pressure or new initiatives). The interventions financed by the instrument must aim towards achieving internationally agreed goals, including the SDGs and the Paris Agreement.

The major innovation of the new instrument is that it merged into one regulation an extra-budgetary fund (EDF), one decision[22] and nearly a dozen of regulations governing predecessor thematic and geographical programmes, including the Development Cooperation Instrument (DCI), the European Neighbourhood Instrument (ENI), the Partnership Instrument for Cooperation with Third Countries (PI), the European Instrument for Democracy and Human Rights (EIDHR), the European Fund for Sustainable Development (EFSD) and the Instrument contributing to Stability and Peace (IcSP).[23]

Another major advantage of the instrument is its increased flexibility, with the possibility to re-use unspent funds on a multi-annual basis and to resort to the rapid response, and the cushion feature of the instrument.[24] The new instrument unifies grants, blending operations and guarantees. It purports to finance external action in multiple forms: grants (which is the focus of this article) but also budgetary guarantees and financial instruments including blended finance operations (through concessional loans and guarantees to mobilise private investment).[25]

NDICI-Global Europe does not exclude in principle the financing of bilateral cooperation with more advanced economies, including China or even Australia or the United States. However, it is mainly geared towards the financing of development assistance, as 93% of its expenditure must fulfill the criteria for Official Development Assistance (ODA) established by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD).[26] In the same spirit, the regulation of the new instrument sets forth that it should contribute to the EU target of providing 0.7 % of its collective Gross National Income (GNI) as ODA within the timeframe of the 2030 Agenda. Several other quantitative targets are established under the instrument's regulation, reflecting cross-cutting strategic and spending priorities of the EU external action, ranging from human development[27] and climate change[28] to spending on gender equality objectives.[29] The instrument also specifically addresses good governance, democracy and human rights, migration and mobility.

With its overall budget of 79.5 billion Euros, NDICI-Global Europe channels the biggest part of EU external action funding. The geographic pillar has the largest share of the instrument's envelope (about 75%), while the thematic programme represents approximately 8% and 12% is reserved for the emerging challenges and priorities cushion. The rapid response actions represent only 4% and the remainder is allocated for support expenditure.[30]

Many consider this reform of the EU financial architecture to be the most significant concerning EU external action and development policy in decades.[31] The role of the European Parliament has increased by taking part of the strategic decisions of the new instrument and the values of the EU are further promoted by providing for a suspension of assistance should a country fail to observe the principles of democracy, human rights and the rule of law.[32]

3. The 2018 EU Financial Regulations and the new financial framework agreements with MDBs

While the previous section presented the 2021 restructuring of the EU financial architecture for external action, with a focus on the main financial instrument dedicated to such action (NDICI-Global Europe), the principles and rules governing the establishment, implementation and control of the EU budget are prescribed in the EU financial regulations entered into force on 2 August 2018.[33] As a result, the EU and its implementing-partner MDBs have entered into new Financial Framework Partnership Agreements (FFPAs) to establish the terms of their relationship in accordance with the 2018 Financial Regulations.

3.1. Indirect management of EU funds through pillar assessed MDBs: actors and approaches

The European Commission is responsible for the implementation of the EU budget in cooperation with the EU Member States.[34] The Directorate-General Cooperation and Development (DG-DEVCO), renamed as of 2021

[22] Decision (EU) 2018/412 of 14 March 2018 amending decision No 466/2014/EU granting an EU guarantee to the European Investment Bank against losses under financing operations supporting investment projects outside the Union (External Lending Mandate, ELM).

[23] See Beatrix Immenkamp, *A new Neighbourhood, Development and International Cooperation Instrument – Global Europe* (July 2021), EPRS, European Parliament.

[24] Lilyanova (2021), supra note 6 at 26.

[25] Supra note 19 art 27.

[26] Supra note 19 art 3, para 4.

[27] See supra note 19 para 22 of preamble: "[…] actions under the Instrument are expected to contribute at least 20 % of the ODA funded under the Instrument to social inclusion and human development, including basic social services, such as health, education, nutrition, water, sanitation and hygiene, and social protection, particularly to the most marginalized."

[28] See supra note 19 para 49 of preamble :" […] Actions under the Instrument are expected to contribute 30 % of its overall financial envelope to climate objectives."

[29] See supra note 19 para 44 of preamble " […]At least 85 % of new actions implemented under the Instrument should have gender equality as a principal or a significant objective, as defined by the gender equality policy marker of the OECD Development Assistance Committee."

[30] Amelia Padurariu, *A General Survey of Development Policy* (September 2021), Fact Sheets on the European Union.

[31] See Aline Burni, Benedikt Erforth and Niels Keijzer, *Global Europe? The new EU external action instrument and the European Parliament* (8 October 2021), at 1.

[32] See supra note 19 para 40 of preamble.

[33] Supra note 2.

[33] Treaty on the Functioning of the European Union (TFEU) art 317.

the Directorate-General International Partnerships (DG-INTPA), is responsible for formulating the international partnership and development policy of the EU. It covers the regions of Africa, Latin America and the Caribbean (including Overseas Countries and Territories), the Middle East, Asia and the Pacific. The Directorate-General for Enlargement and Neighbourhood Negotiations (DG-NEAR) on the other hand, is responsible for EU enlargement policy and the Eastern and Southern neighbourhood. Partner organisations receiving EU funds may engage in negotiations with different directorates of the EC, depending on the geographical coverage of the action to be financed and on the nature of the EU contribution.

Regardless of the financial instrument used to channel EU funds to a project or programme, the 2018 Financial Regulations shall apply. They provide for the rules governing the implementation of EU funds from the budget. The EC may resort to three possible methods of budget implementation:[35] (i) direct management by its departments or through its executive agencies which represents about 18% of the EU budget, (ii) shared management jointly with EU Member States, which represents three quarters of the budget, or (iii) indirect management by entrusting budget implementation tasks to other entities such as third countries and international organisations, which represents 8% of the EU budget.[36] This chapter focuses on EC indirect management of the EU budget through MDBs.

The 2018 Financial Regulations contemplate a wide range of EU external action partners for the implementation of EU funds. The EU seeks to promote joint efforts and coordinated action among EU actors in the implementation of EU funds, especially through the Team Europe' approach. It emerged in April 2020 as part of the EU global response to the COVID-19 pandemic.[37] Team Europe consists of the EU, its Member States (including their implementing agencies and their public development banks), as well as the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD). While the membership of Team Europe is delineated, Team Europe develops working relationships with other partners on specific projects. The Team Europe approach is now a brand name for EU interventions beyond COVID-19 initiatives and aims at pulling together financial resources from the team members. It proposes a mix of implementation modalities to enhance impact and visibility of EU action, especially to address global challenges. The Team Europe approach is applied under the NDICI-Global Europe new financial instrument through the Team Europe Initiatives (TEIs) which finance high impact projects in key sectors by combining resources from Team Europe members willing to work together in the design, financing and implementation of actions.[38] To complement the Team Europe approach, NDICI-Global Europe promotes the "working together approach" by privileging joint programming between European institutions and Member States in a given country or region.[39] TEIs are largely built on joint programming processes between the EU and its Member States.

International organisations and in particular MDBs have been long standing implementing partners for the EU, receiving and administrating EU funds. Article 156 of the 2018 Financial Regulations specifically contemplates 'Indirect management with international organisations.' However, this requires ex-ante pillar assessments of the organisations' systems before the EU can rely on the policies, rules and procedures of such organisations for the implementation of EU funds.[40]

MDBs willing to manage EU funds shall thus accept to undergo pillar assessments of their systems in accordance with terms of reference elaborated by the EC.[41] Pillar assessments conducted by the EC are institutional compliance assessments on specific systems, rules and procedures of a partner organisation which the latter shall pass to be able to rely on its internal systems and apply its own policies and rules when implementing EU funded projects.

The organisation must substantially meet the conditions set forth in Article 154(4) of the 2018 Financial Regulations, detailed as follows:

> [...](a) set up and ensure the functioning of an effective and efficient internal control system based on international best practices and allowing in particular to prevent, detect and correct irregularities and fraud;
>
> (b) use an accounting system that provides accurate, complete and reliable information in a timely manner;
>
> (c) it [is] subject to an independent external audit, performed in accordance with internationally accepted auditing standards by an audit service functionally independent of the person or entity concerned;
>
> (d) apply appropriate rules and procedures for providing financing to third parties, including transparent, non-discriminatory, efficient and effective review procedures, rules for recovering funds unduly paid and rules for excluding from access to funding;
>
> (e) make public adequate information on their recipients equivalent to that provided for under Article 38 [of the 2018 Financial Regulations]; and

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[35] Regulation (EU, Euratom) No. 2018/1046 art 62.

[36] See–<https://european-union.europa.eu/institutions-law-budget/budget/spending_en> (Official website of the European Union), accessed 8 June 2022)

[37] See –<https://europa.eu/capacity4dev/wbt-team-europe> (Official website of the European Union), accessed 8 June 2022.

[38] *La politique européenne de développement*, supra note 3.

[39] Manual Manrique Gil, *Europa Global: La gestación de la nueva arquitectura de la politica de cooperación para el desarollo de la Unión Europea* (Junio 2021), at 17-18.

[40] See Regulation (EU, Euratom) No. 2018/1046 art 154(3).

[41] Commission Decision of 17 April 2019 on establishing new terms of reference for the pillar assessment methodology to be used under Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council.

(f) ensure protection of personal data equivalent to that referred to in Article 5 [of the 2018 Financial Regulations].

When the organisation only partially complies with the above requirements, the EC may take appropriate measures which shall be reflected in the relevant contribution agreement signed between the EU and the MDB.

Prior to the adoption of the 2018 Financial Regulations, many MDBs had already completed the core mandatory pillars of internal control, accounting system, external audit as well as the procurement and the sub-delegation pillars. Before 2018, fewer MDBs had engaged in the assessments related to the optional grant and financial instruments pillars, which trigger assessments of the corollary pillars of exclusion from access to funding, publication of information on recipients and protection of personal data. However, the elimination of the sub-delegation pillar[42] following the adoption of the 2018 Financial Regulations, coupled with the large amounts made available by the EU for new blending facilities and guarantees, prompted MDBs to undergo optional pillar assessments.

At the time of this writing, major MDBs have completed or are in the process of finalising the ex ante pillar assessment exercise. This is the prelude for the opening of negotiations with the EC on the financial framework agreements governing the administration of EU bilateral contributions by MDBs.

3.2. Financial Framework Agreements governing the administration of EU funds by MDBs

The EC has developed standard contractual arrangements for the implementation of projects by pillar-assessed organisations. They are denominated Contribution Agreements[43] (formerly known as Delegation Agreements) and consist of Special Conditions and General Conditions. A Contribution Agreement is usually signed between the EU represented by the EC as Contracting Authority and the MDB, designated as the Organisation. The Contribution Agreement documentation reflects the 2018 Financial Regulations and replaces the prior standard terms for managing EU funds called Pillar Assessed Grant or Delegation Agreements (PAGoDA). Following the 2018 update to the EU financial regulations, the EC has engaged in the negotiation of Financial Framework Partnership Agreements (FFPAs) with partner organisations for the implementation of EU funds through indirect management.[44] The former Financial and Administrative Framework Agreements or Framework Arrangements, as the case may be, are repealed upon the entry into force of the newly negotiated FFPAs.

The FFPAs purport to establish the extent and modalities of cross-reliance on systems, rules and procedures of a pillar-assessed organisation. MDBs have engaged in negotiations with the EC to reflect their specificities in the implementation of the standard provisions of the Contribution Agreement, by adding derogative, supplementary or interpretative provisions. The terms of the relevant FFPA typically apply to all EU contributions provided to an MDB managing projects or programmes financed or co-financed by the EU.

3.3. Action specific Contribution Agreements

A project specific Contribution Agreement shall typically be signed between the EU and the MDB managing an EU bilateral contribution provided in the form of a non-reimbursable financing (grant). The Special Conditions of the Contribution Agreement include project specific information such as the name of the project (called the "Action"), the amount of the EU contribution, the remuneration of the MDB expressed as a percentage rate and the Implementation Period of the Action. The annexes of the Contribution Agreement include the Description of the Action (Annex I) and the budget (Annex III). Annex II consists of the applicable General Conditions of the Contribution Agreement. While MDBs as pillar-assessed organisations may rely on their own grant and eligible expenditure policies, additional requirements stemming from the standard terms of the Contribution Agreement, as complemented and clarified by the FFPA, shall apply to the Action.

3.3.1. The concept of "Grant"

The term of "grant" may have different meanings under the EU and the relevant MDB terminology. Pursuant to the EU normative framework, there are two main types of grants, "action grants" which fund a specific action aimed at achieving policy objectives of the EU, and "operation grants" which finance the operating costs of an organisation pursuing an objective supporting EU policies.[45] EU grants are governed by the following principles: transparency and equal treatment of applicants, the no-profit rule of the action covered by the grant, the non-cumulation of EU grants per action, the non-retroactivity rule excluding actions already completed, co-financing (grant beneficiaries shall pay part of the costs of the Action), and the nationality rule (applicants must be established in an eligible country). EU grants may be awarded directly (exceptionally) or following a competitive procedure through a call for proposals. Further, they may be implemented by direct or indirect management. In the latter case (which is the focus of this article), an MDB fills the role of contracting authority. Since the elimination of the Sub-delegation pillar, following the entry into force of the 2018 Financial Regulations, MDBs are administrating EU non-reimbursable contributions under the Grant pillar.

[42] The sub-delegation pillar has been taken over by the grant and the financial instruments pillars under the 2018 Financial Regulations.

[43] This article is based on the May 2022 version of the Contribution Agreement template.

[44] See Regulation (EU, Euratom) No. 2018/1046 art 130.

[45] –<https://ec.europa.eu/international-partnerships/grants_en> (Official website of the European Commission), accessed 8 June 2022.

Besides, under the General Conditions of the Contribution Agreement, the term of "Grant" refers to the financial contributions provided by the MDB to a third party and shall not be confused with the EU contribution provided to the MDB by the EC as Contracting Authority acting through indirect management. In addition, the term of "Grant" under the Contribution Agreement shall be distinguished from another situation where the EU provides grants under direct management to beneficiaries pursuant to Title VIII (Grants) of the 2018 Financial Regulations. In such a case, pursuant to Article 154(7) of same financial regulations, when assessed persons or entities (including MDBs) participate in a call for proposals, they shall comply with the rules for calls for proposals set forth in Title VIII (Grants) but would sign a contribution agreement or financing agreement instead of a grant agreement.

3.3.2. The concept of "Action" and "overall Action"

A project or programme partly or fully financed by the EU is designated as an "Action," which is further detailed in Annex I of the Contribution Agreement, the "Description of the Action." Even if a component is entirely financed by another donor, it will nevertheless be part of the "Action" if it appears in the Description of the Action. This will bear consequences as reporting and other obligations applicable to the management of EU funds will apply.

On the other hand, the concept of "overall action" designates a broader project or programme than the Action to be implemented during the Implementation Period specified in the Contribution Agreement. It is relevant in the context of a Multi-Donor Action[46] where the project to be implemented goes beyond the Implementation Period established in the Contribution Agreement. In this case, the EU as Contracting Authority may request, in addition to the final report of the Action, the final report of the "overall action". However, there shall be no link between the provision of the overall action final report and the final payment made pursuant to Article 18 of the General Conditions of the Contribution Agreement. Indeed, the final payment under the Contribution Agreement is made following determination of the final amount of the EU contribution after approval by the EU of the final report of the Action (and not the overall action report). For the avoidance of doubt, MDBs may clarify in the Contribution Agreement that activities in connection with the project which are not specified in the Description of the Action shall not be subject to the terms of the Contribution Agreement, including the submission of a management declaration.

3.3.3. Responsibility for the implementation of the Action

While pursuant to a Grant Agreement signed between the MDB channelling EU funds and the Grant Beneficiary, the latter becomes responsible for the implementation of the project and owns the results, nevertheless pursuant to Article 2.1 of the General Conditions of the Contribution Agreement, the MDB as signatory of the Contribution Agreement with the EU remains responsible for the implementation of the Action towards the EU. This is regardless of whether the activities are performed by the MDB itself, a contractor or a Grant Beneficiary. The MDB is held responsible for the performance of its contractual obligations under the Contribution Agreement as well as for those of other implementing partners, including Grant Beneficiaries. As a consequence, MDBs not only mirror the demanding requirements for the use of EU funds into the Grant Agreements they sign with Grant Beneficiaries, but they also strive to put in place strict monitoring and audit arrangements to ensure a proper project implementation by Grant Beneficiaries.

Section 3 above presented the context of the new financial framework partnership agreements negotiated by MDBs with the EU to complement the standard terms of the Contribution Agreement. Section 4 that follows will now address the contents of such standard terms which will have to be 'transposed' into the Grant Agreements between the MDBs and the Grant Beneficiaries of EU funds.

4. Highlight of EU specific legal requirements in MDB Grant Agreements signed with beneficiaries of EU bilateral contributions

This section features EU specific requirements of particular interest to MDBs reflected in the Grant Agreements they sign with beneficiaries of EU funded projects. It will be more descriptive as it is too early to assess the extent to which new obligations for the implementation of EU funds cause transposition challenges for MDBs and whether they faciliate the achievement of EU objectives.

4.1. EU Terminology in the Grant Agreement

Following the signature of a Contribution Agreement between the Contracting Authority (the EU) and the Organisation (the MDB) under which the terms and conditions of the implementation of the Action are established for the management of EU funds, the MDB may enter into a Grant Agreement with the Grant Beneficiary (a third-party receiving EU funds entrusted with the MDB) in order to implement an EU funded project or programme. Such Grant Agreement should reflect major project specific information set forth in the Contribution Agreement. Most obligations of the MDB towards the EU set forth in the Contribution Agreement are mirrored into the Grant Agreement signed by the MDB with the Grant Beneficiary. If the grant is awarded by a call for proposals, the terms of the guidelines for applicants establishing conditions for disbursement, reporting, auditing and monitoring arrangements shall also be reflected in the Grant Agreement.

[46] For example, when part of the Action is exclusively financed by the implementing MDB and/or other donors.

4.1.1. The concept of "eligible costs."[47]

A distinction shall be made between direct eligible costs of the Action which are necessary to carry out the Action and are directly attributable to its implementation, and indirect costs which may not be identified as costs directly linked to the Action and may be captured by the remuneration of the Action. This paragraph focuses on direct eligible costs,[48] which can be charged on an actual basis or declared under simplified costs options[49] through a combination of unit costs, lump sums and flat-rate financing.

In order to be eligible for EU financing, direct "eligible costs" shall meet the conditions set forth in Article 16.1 of the General Conditions of the Contribution Agreement[50] and shall supplement eligible expenditures established in the applicable MDB policies and rules. In particular, direct "eligible costs" under EU terminology are based on a costs incurred definition (activities shall be implemented, services rendered, works completed and supplies delivered) and not on an allocation of funds concept based on contracting and committed funds. Another eligibility feature specific to EU bilateral contributions is that the direct costs of the Action shall be covered by one of the budget sub-headings indicated in the estimated budget set forth in Annex III (Budget) and the activities described in Annex I (Description of the Action) of the Contribution Agreement. Therefore, the budget of the Grant Agreement shall be carefully prepared in line with the budget of the Contribution Agreement. Any discrepancies may result in ineligible costs at the charge of the MDB. Further, during the course of the implementation of an EU funded project, modifications of the budget under the Grant Agreement may require EU approval by way of an amendment of the Contribution Agreement.[51]

An EU contribution subject to a single Contribution Agreement may be channelled through several Grant Agreements signed between the MDB and Grant Beneficiaries. Therefore, coordination of the MDB project teams with the departments or units responsible for managing fiduciary accounts is paramount to ensure a smooth implementation of the project in accordance with the EU approved budget.

In addition, direct costs are eligible for EU financing if they comply with the usual practices of the pillar-assessed MDB and with the fundamental principle of Sound Financial Management overarching the implementation of EU funds, namely economy, effectiveness and efficiency (including internal control aspects). Last but not least, the costs shall be incurred during the Implementation Period set forth in the Contribution Agreement and reflected in the Grant Agreement and shall comply with applicable tax and social legislation with due respect to privileges and immunities of the relevant MDB.

4.1.2. Important timeframes and deadlines for EU funded grants

The concept of Contracting Deadline, i.e. the date at which no further contracting can take place to ensure that costs be incurred timely, by the end of the Implementation Period, was deleted from the 2018 Financial Regulations. As of 2018, the core deadline governing the implementation of the Action is the end of the Implementation Period specified in the Special Conditions of the Contribution Agreement. Under the Grant Agreement, the end of the Implementation Period is often referred to as the Completion Date and on that date no further costs can be incurred except for costs incurred for the closure of the project (completion report, audit, etc.). The End Date is another deadline specific to EU financing (appearing in the Contribution Agreement) which shall also be reflected in the Grant Agreement. By the End Date, all payments to third parties shall be completed, the final report of the project shall be accepted by the MDB and any returns of fund shall have been made by the Grant Beneficiary to the MDB. The End Date is extended until the completion of any dispute settlement procedure and has thus the particularity of being an expandable deadline. The document retention period is based on the expandable End Date and obliges the Grant Beneficiary and its contractors or suppliers until then.

The Grant Agreement should also reflect other relevant contractual deadlines, especially those which are grounds for termination under the Contribution Agreement.[52]

4.1.3. Tax avoidance

One of the novelties of the 2018 Financial Regulations is the emphasis around the prevention of tax fraud, tax evasion and tax avoidance as important conditions attached to the use of EU funds under indirect management.[53] Tax evasion and tax fraud refer to the use of illegal practices to avoid

[47] The concept of eligible costs is not relevant for performance-based financing which is governed by Article 19 of the General Conditions of the Contribution Agreement.

[48] See Article 16.1 of the General Conditions of the Contribution Agreement.

[49] See Article 16.6 of the General Conditions of the Contribution Agreement.

[50] Pursuant to Article 16.1 of the General Conditions of the Contribution Agreement, direct costs are eligible for EU financing if they meet all the following criteria:
a) they are necessary for carrying out the Action, directly attributable to it, arising as a direct consequence of its implementation and charged in proportion to the actual use;
b) they are incurred in accordance with the provisions of this Agreement;
c) they are actually incurred by the Organisation, i.e. they represent real expenditure definitely and genuinely borne by the Organisation, without prejudice to Article 16.6;
d) they are reasonable, justified, comply with the principle of Sound Financial Management and are in line with the usual practices of the Organisation regardless of their source of funding;
e) they are incurred during the Implementation Period with the exception of costs related to final report, final evaluation, audit and other costs linked to the closure of the Action which may be incurred after the Implementation Period;
f) they are identifiable and backed by supporting documents, in particular determined and recorded in accordance with the accounting practices of the Organisation;
g) they are covered by one of the sub-headings indicated in the estimated budget in Annex III and by the activities described in Annex I; and
h) they comply with the applicable tax and social legislation taking into account the Organisation's privileges and immunities.

[51] For instance, an amendment under the Contribution Agreement with the EU is needed in case of transfer between budget headings involving a variation (in cumulative terms) of 25% or more of the original amount in relation to each concerned heading.

[52] The May 2022 version of the Contribution Agreement stipulates in a new Article 17.6 of the General Conditions that a Contribution Agreement is terminated if the EU does not process a payment within two years of its entry into force.

[53] See Regulation (EU, Euratom) No. 2018/1046 art 155(2).

paying taxes, for example by not declaring profits or using various ways to avoid paying VAT.[54] Tax avoidance refers to the use of legal instruments in order to reduce as much as possible tax liabilities, for example by shifting profits to a low tax country or by the use of aggressive tax planning (without sound business reasons). Projects receiving EU financing should not be structured for the purpose of contributing to tax avoidance. MDBs should refer for guidance to the Communication from the Commission on new requirements against tax avoidance in EU legislation governing in particular financing and investment operations of 21 March 2018 (COM (2018) 1756). The obligations of MDBs in this respect are deemed to be met upon compliance with their respective rules and procedures for exclusion from access to funding, to the extent the latter have been positively pillar assessed. Ad hoc measures may also complement MDB rules.[55] Checks for tax avoidance are typically performed by MDBs at the time of contract signature with the Grant Beneficiary and before disbursement of EU funds. Where EU support is provided through financial instruments and/or budgetary guarantees (which is not addressed in this article), compliance with EU list on non-cooperative jurisdictions shall apply in addition to the legal provisions regarding tax avoidance.

4.1.4. Contracting and Early Detection and Exclusion System

EU specific integrity provisions often come to complement the standard prohibited practices established in the MDB policies (fraud, corruption, collusion, coercion and obstruction) typically covered by cross-debarment in accordance with the Agreement for Mutual Enforcement of Debarment Decisions Among Multilateral Development Banks of 9 April 2010.

In this respect, the Early Detection and Exclusion System[56] of the EU (EDES) aims at protecting the Union's financial interests against unreliable persons or entities applying for EU funds. It lists entities and persons excluded from EU funding. The EC provides full access to the EDES database upon request to any person or entity involved in the implementation of EU funds, including MDBs administrating EU funds. MDBs managing EU funds shall inform the EU of: (i) a situation of exclusion pursuant to the MDB own positively assessed policies and rules and any ad hoc provisions stipulated in the Special Conditions of the Contribution Agreement; and/or (ii) any detection of a fraud or irregularity pursuant to Article 2.6 of the General Conditions of the Contribution Agreement.

In managing EU funds, MDBs shall apply reasonable measures in accordance with their policies and procedures to ensure exclusion of potential candidates, tenderers or applicants participating in a procurement or grant award procedure or from the award of a procurement contract or grant financed by an EU contribution, where such participants or awardees engage in activities which may threaten the financial interests of the EU.

In connection with reasonable measures to be adopted by MDBs to detect irregularities affecting the EU financial interests and in particular entities created under a different jurisdiction with the intention to circumvent fiscal, social or any other legal obligations, the MDBs may obtain and rely on: (i) a recent extract from the judicial record or an equivalent document issued by a judicial or an administrative authority in the country of establishment or incorporation showing that the requirements are satisfied, or if these are not available, a sworn declaration[57] from the legal representative of the relevant entity; and (ii) the information made available in the EDES.

The above-mentioned exclusions and obligations of information should be reflected in the respective Grant Agreement passed on to the Grant Beneficiary. The latter may in turn take similar reasonable measures to ensure that itself and the third parties with whom it may contract do not engage in activities which may threaten EU financial interests, causing their inclusion in the EDES database. Grant Beneficiaries may also rely on a sworn declaration from candidates, tenderers or applicants. Further, Grant Beneficiaries are required to inform third parties that any irregularity causing their exclusion from the award of a contract will be communicated to the MDB and may be published in the EDES.

4.1.5. Procurement

Pursuant to the new Article 2.2 of the May 2022 version of the General Conditions of the Contribution Agreement, an MDB may apply its own rules and procedures regarding procurement contracts and/or the award and management of grants but only if this is contemplated in the Special Conditions of the Contribution Agreement. Further, ad hoc measures reflecting EU specific requirements may complement the MDB's rules and procedures applicable under the Grant Agreement signed with the Grant Beneficiary. In this regard, integrity provisions for contractors may be stricter than usual in connection with tax avoidance or compliance with social legislation. In addition, the rules of origin and nationality of the MDBs with respect to procurement shall not be more restrictive than the applicable EU eligibility criteria.

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[54] See Contribution Agreement Manual – November 2021. The new manual reflecting the May 2022 version of the Contribution Agreement template has not been published yet at the time of this writing.

[55] See Article 2.2 of the General Conditions of the Contribution Agreement.

[56] "Early Detection and Exclusion System" means the system set up by Regulation (EU, Euratom) No 2015/1929 of 28 October 2015, as further amended or substituted, on the financial rules applicable to the general budget of the Union (OJ L 286/1, 30.10.2015) which includes information on the early detection of risks threatening the EU financial interests, on the cases of exclusion from EU funding of legal and natural persons and on the cases of imposition of financial penalties, as available in the official EU website: https://ec.europa.eu/info/strategy/eu-budget/how-it-works/annual-lifecycle/implementation/anti-fraud-measures/edes_en, or on any successor page, as amended and supplemented from time to time.

[57] A sworn declaration certifying that the entity is not falling under exclusions from access to funding of the MDB.

4.1.6. EU restrictive measures

Without prejudice to any other specific contractual arrangement set forth in the FFPA, EU sanctions shall apply to projects or programmes financed by EU bilateral contributions and complement any other sanctions regime applicable by the pillar assessed MDB (such as UN sanctions). EU sanctions may include arms embargoes, travel bans, asset freezes and other economic measures such as restrictions on imports and exports. The strict application of EU restrictive measures is at the heart of the protection of the Union's financial interests and should apply to all EU contributions pursuant to the FFPAs. Typically, the provision relating to EU restrictive measures in the FFPAs requires MDBs to ensure that no economic resources are made available, directly or indirectly, to or for the benefit of entities, individuals or group of individuals, designated by the EU as subject to restrictive measures in the lists provided at www.sanctionsmap.eu.

In the event that any EU fund recipient falls under the scope of EU restrictive measures, the MDB shall inform the EC and the parties shall consult with each other to determine remedial measures in the spirit of cooperation. Such measures may consist in reallocating EU funds or obtaining recovery of misused funds.

The monitoring of EU restrictive measures shall be reflected in the Grant Agreement signed between the MDB and the Grant Beneficiary. The latter shall not make available EU funded grant proceeds, directly or indirectly, to sanctioned persons as established in the sanctions map website. Further and to ensure better compliance with this obligation, Grant Beneficiaries should include the EU restrictive measures provision in the contracts with their sub-contractors. Compliance with EU restrictive measures down the chain of EU fund recipients should be particularly monitored in the context of international conflicts such as the war in Ukraine.

4.1.7. Enhanced Audit, Monitoring and Evaluation Arrangements

The use of EU funds entails stricter scrutiny on beneficiaries and projects. The Grant Agreement shall reflect that Grant Beneficiaries may be subject to visits and audits carried out directly by representatives of the EC or other EU bodies[58] (such as the EU Court of Auditors or the EU anti-fraud office (OLAF)). This is in addition to the MDB's monitoring and audit arrangements.

Further, the Grant Agreement shall establish requirements for document retention which are in line with Article 15.1 of the General Conditions of the Contribution Agreement. As such, financial and procurement information regarding the implementation of the EU financed project shall be kept for a period of at least five years from the End Date[59] and in any case until any on-going audit, verification, appeal litigation, claim or investigation has been disposed of.

Pursuant to Article 2.6 of the General Conditions of the Contribution Agreement, the MDB may specify in the Grant Agreement that claims regarding misuse of funds in the implementation of the project may be assigned to the EU as donor, so the latter can proceed itself with the recovery of amounts due under the Grant Agreement (by way of set-off under other agreements between the EU and the Grant Beneficiary or otherwise).

In addition to and distinctly from the financial verifications, another special arrangement tied to the use of EU funds is the requirement for MDBs to invite representatives of the EC/Contracting Authority to take part in the main monitoring and evaluation missions of a given EU financed project and submit the resulting reports.[60] The EC/Contracting Authority shall also be invited to provide comments to the terms of reference preceding the occurrence of an evaluation exercise. Besides, the EU institutions may also take the initiative at their own costs to perform monitoring and evaluation missions and shall inform the MDB to mutually agree on procedural matters in advance. The above is without prejudice to the provisions agreed in the respective FFPA. As a result, the Grant Agreements shall reflect such rights of the EC/Contracting Authority and the Grant Beneficiaries shall collaborate in the preparation and realization of such missions.

4.1.8. Protection of personal data

Protection of personal data is one of the mandatory pillars triggered by the grant or the financial instruments optional pillars, along with exclusion from access to funding and publication of information on recipients. For as long as the policies and procedures regarding the protection of personal data of the assessed MDB have not been positively assessed, ad hoc measures may apply to the existing MDB policies and procedures to ensure a level of protection of the EU's financial interests equivalent to that existing when the EC implements the budget itself. While the General Data Protection Regulation (GDPR) is deemed to comply with the requirements on the protection of personal data for purposes of the 2018 EU Financial Regulations, the application of the GDPR is not required for international organisations. Besides, Grant Beneficiaries and their contractors are merely required to comply with their applicable national laws and regulations on data protection.

[58] See Article 15 of the General Conditions of the Contribution Agreement.

[59] See paragraph 4.1.2 hereinabove.

[60] See Article 9 of the General Conditions of the Contribution Agreement.

5. Conclusion

This article presented the legal and institutional framework governing EU funded grants administrated by MDBs for EU external action/development projects. It covered the recent developments in the EU financial architecture and identified the main financial instrument at use for EU external action (NDICI-Global Europe). In addition, it showed how the 2018 Financial Regulations – as complemented by the terms of the recently negotiated FFPAs– are reflected in the new Contribution Agreements concluded between MDBs and the EU for the administration and implementation of EU funded Actions. Finally, the article described how Grant Agreements signed between the Grant Beneficiaries and the MDBs entrusted with the administration of EU bilateral contributions mirror substantially obligations of the MDBs set forth in the relevant Contribution Agreements.

During the EU ex ante pillar assessment process, MDBs have taken the opportunity to update their internal policies and procedures to better align them with the requirements of this major donor which is the EU. However, more changes are to come. Institutional discussions have indeed already started at the EU level for a revision of the financial regulations to better adapt them to the newly adopted 2021-2027 MFF. This well illustrates how administrating EU funds comes with a high transaction cost for MDBs. In addition to observing and transposing into their EU funded agreements an array of demanding obligations, MDBs shall adapt to a legal framework in constant evolution. However, recent developments show that the EU strives to simplify its financial architecture and builds on lessons learned from implementation difficulties. It is thus instrumental for MDBs to engage with the EU and comment on the practical implications of the new legal requirements. Such dialogue is essential to bring about improvements as the applicable legal framework evolves. The mid-term review of the FFPAs will be an opportunity for such a dialogue. It will serve the goal of facilitating MDB implementation of EU funds, which will in turn better support the EU in achieving its objectives.

The Role of In-House Counsel in **Driving the Climate Agenda**

Vesselina Haralampieva[1]

Abstract: Climate change is a risk multiplier across society and has multiple implications on the rule of law and the way lawyers practice law in different jurisdictions. This article discusses the role of lawyers, with a particular focus on the in-house lawyer, in reaching the Paris agreement mitigation and adaptation goals by taking stock of the changing policy, regulatory and business context and the recent Law Society of England and Wales' Resolution on Climate Change.

1. Introduction: the climate emergency

There is no doubt that the growing threat of climate change will define this century and this generation more dramatically than any other. It is widely recognised by scientists and environmentalists alike that we have a small window of opportunity to halt the warming of the Earth to prevent it from becoming unsustainable to support the natural resources upon which modern societies are built. If left unchecked, climate change will bring about, in all likelihood, profound economic problems including financial instability, disruption of production, worsening living standards and wellbeing, and political insecurity.

The World Economic Forum (WEF) lists climate action failure, extreme weather and biodiversity loss as the top three global risks ranked by severity over the next 10 years in its 2022 Global Risks Report.[2] Emerging economies and developing countries – where the majority of international financial institutions (IFIs) operate – are particularly vulnerable to climate change. For example, over the last couple of years, we have seen the devastating impact of wildfires in Turkey, Greece and Bulgaria, as well as flooding in Central Europe and Southeast Asia, and droughts in Central Asia and North Africa. The costs of these events could be measured in lost livelihoods, lost homes, lost businesses and billions of euros in emergency services and disaster relief but ultimately, in some cases, loss of life.

Against this backdrop, it is no surprise that the climate crisis is having profound implications for the rule of law and the lives and businesses of lawyers' clients. The UN Human Rights Council,[3] the International Covenant on Civil and Political Rights (ICCPR), some domestic courts and international bodies have recognised that climate change[4] poses serious risks to fundamental human rights. Accordingly, the climate crisis is also shaping the way in which lawyers practise in different jurisdictions.

The world in which we practise law is changing rapidly as societies are embarking on an unprecedented journey to combat the climate crisis, consisting of efforts centred around the concepts of low-carbon, and just, resilient and sustainable development. This changing reality, I argue, provides a new context for construing the legal principles and/or duties, which we – in-house counsel at IFIs – abide by as members of the legal profession in our respective jurisdictions, on the one hand, and as trusted legal advisers in the organisations where we work, on the other.

2. A changing context and the legal profession

Averting the worst possible consequences of climate change will require no less than a large-scale transformation of both economy and society, supported by re-direction of capital. Financial markets and institutional investors are increasingly shifting towards sustainable investments. For example, the Global Financial Alliance for Net Zero (GFANZ) sits on more than US$ 130 trillion of capital committed to adopting high-ambition, science-based targets, including achieving net-zero emissions by 2050.[5] Similar commitments were recently announced by 100 Financial Times Stock Exchange (FTSE) companies and other large organisations.

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[2] World Economic Forum, 'The Global Risk Report'<https://www.weforum.org/reports/global-risks-report-2022/> accessed 7 November 2022.

[3] United Nations Human Rights Office of the High Commissioner, 'Human Rights Council Resolutions on Human Rights and Climate Change' <https://www.ohchr.org/en/climate-change/human-rights-council-resolutions-human-rights-and-climate-change> accessed 5 November 2022.

[4] It is widely recognised that climate change is part of the tri-partite global crisis (alongside air pollution and biodiversity).

[5] Its 450 members represent an astonishing 40 percent of the world's financial assets under management. They will all now work to meet global net zero by 2050.

Voluntary commitments, albeit laudable, will not suffice to avert the climate crisis. Increasingly, policymakers and regulators are taking measures to ensure market stability by mandating disclosure of organisations' governance and management of climate-related risks. In the light of these regulatory shifts, there has never been a more important time for lawyers to contribute to the climate and broader sustainability agenda. While at first glance it may appear that the area is one for specialist environmental and climate change lawyers in large firms and organisations, the broad implications for business and society arising from the climate crisis require a response from lawyers from all sectors. Indeed, lawyers are increasingly expected to understand how climate-related risks and attendant legal risks affect their clients, the matters they advise upon and their practice areas. More specifically, in-house lawyers will have to assess the legal implications of climate change and how these have an impact on their employers and, in turn, on their employers' clients, shareholders and broader groups of stakeholders.

More broadly, the understanding of the crucial role of the lawyer underpins the position taken by many bar associations and law societies over the last couple of years, including the American Bar Association,[6] the International Bar Association,[7] the Law Society of England and Wales[8] and many other European Bars. In their joint international meeting on climate change in March 2022, more than 15 bodies representing the legal profession have recognised the significant role lawyers can play in "*leading climate action*" and "*leading on climate justice to protect the rule of law, access to justice and the public interest*".[9] There has been also a recognition that lawyers should practise in a "*climate-conscious*" way, which is central to the Climate Change Resolution of the Law Society of England and Wales of November 2021.

Climate-conscious lawyering rests on the understanding that climate change is increasingly a source of financial risk to businesses, economies, society and the natural world.[10] Risk registers of organisations typically assess the likelihood of a risk occurring and the scale of impact if it does. Climate risk increasingly scores high for both measures.[11] Climate change may not present the most important risks for every client of every lawyer, but most clients will be affected by it in some way. Solicitors in England and Wales, in particular, are increasingly expected to practise the legal profession in a way that supports the 1.5 degrees Paris Agreement goal (see Paragraph 4 of the climate change resolution).

In particular, the Law Society of England and Wales (similarly to the International Bar Association and a growing cohort of professional legal organisations) urges their members to:

1. Consider the likely impact of any legal matter on the climate crisis and provide competent advice to their clients taking into account the climate mitigation and adaptation objectives of the Paris Agreement,
2. Consider the likely climate-related risks and liabilities for their clients and business,
3. Advise clients, where applicable, about the benefits of disclosure of climate-related risks and opportunities related to their entire business operations,
4. Continue their legal education on matters pertaining to climate change,
5. Engage in pro bono activities that support the Paris Agreement objectives.

In light of this guidance, an English solicitor should consider the extent to which these risks and other climate-related matters will be material to their (i) clients or employer, and (ii) practice, and respond accordingly. It is likely that the response and levels of engagement will vary across different areas of the profession, but ultimately, the lack of engagement on behalf of a solicitor may beckon the question whether they are acting in the best interests of their clients or employers (the latter in respect of in-house lawyers). One may argue that as awareness of the impact of climate change on various practice areas increases, it is reasonable to expect that a competent solicitor should be able to advise clients in order to mitigate their litigation and regulatory risks. Such advice may involve for example, development of credible transition plans (for carbon intensive businesses) and increasing transparency of climate risk management and disclosure (to reduce risks of shareholders' claims). Climate-conscious lawyering is, in fact, consistent with a solicitor's duties, including duties of care and the paramount duty to act in the best interests of their client or employer.

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[6] American Bar Association House of Delegates, 'Resolution Adopted August 12-13 2019' <https://www.americanbar.org/content/dam/aba/directories/policy/annual-2019/111-annual-2019.pdf> accessed 5 November 2022.

[7] International Bar Association, 'Climate Crisis Statement' <https://www.ibanet.org/LPRU/Climate-Crisis 822C1967-F851-4819-8200-2FE298164922.pdf> accessed 5 November 2022.

[8] The Law Society of England and Wales's, 'Creating a climate-conscious approach to legal practice' <https://www.lawsociety.org.uk/topics/climate-change/creating-a-climate-conscious-approach-to-legal-practice#download-the-resolution> accessed 5 November 2022.

[9] Procedural minutes of the international meetings between bars and law societies on climate change, 1 March 2022. Copy is with the author who joined in her capacity as a representative of the Climate change working group of the Law Society of England and Wales.

[10] As emphasised by the Bank of England and financial regulators and supervisors worldwide (see the Network for Greening the Financial Systems), the World Economic Forum, national governments and the United Nations (see COP26 resolutions).

[11] For categorisation of climate-related risks, please visit Bank of England, 'Climate change: what are the risks to financial stability?' <https://www.lawsociety.org.uk/topics/climate-change/creating-a-climate-conscious-approach-to-legal-practice#download-the-resolution> accessed 5 November 2022.

3. Is there a special role for the in-house counsel?[12]

In-house lawyers have a unique role to play in responding to the climate crisis.[13] They are closer to the business and understand how the changing policy and regulatory context is likely to affect it. The general counsel in particular is often a trusted adviser to the board on matters related to good governance, reputation and integrity in the context of climate and environmental, social and governance (ESG) considerations. There is a natural role for the general counsel to guard organisations against deceiving their consumers, shareholders or broader group of stakeholders in believing that the organisation's products are environmentally friendly or have greater positive environmental impact than what is true (*i.e.* greenwashing, which is on the rise). More importantly, in-house lawyers may also steer the discussion at the board towards taking long-term decisions to progress net zero commitments, rather than serving short-term commercial interests.

In addition, in-house lawyers in international organisations, in particular, are asked to support the mandate of their organisation, which is, in many cases, focused on promoting *sustainable development*[14] and advancing transition in emerging markets or developing economies. Similarly, international organisations are expected to act *responsibly*, which, in a business context, generally means to have a material positive impact on society and the environment, having regard to the interests of relevant stakeholders. Given that in-house lawyers provide essential support to their organisations, it is reasonable to expect that they will aspire to provide advice that leads to sustainable and responsible practices across all operations of their organisation. It is conceivable therefore to assume that in-house lawyers should play a leadership role in developing and promoting climate-conscious lawyering. The following actions by in-house lawyers may be taken in furtherance of this role:[15]

1. Advising their board of directors on the importance to develop leadership to respond to the climate crisis, adopt a net zero strategy and ambitious interim goals, and, importantly, be transparent about them.
2. Helping their organisations embed climate and sustainability considerations into their strategic documents, integrating them into the broader business operations and policy engagement or dialogue.
3. Demanding climate-conscious provisions in legal agreements and standard contracts.
4. Requesting procured services to be net zero aligned and working with outside counsel to ensure they adopt sustainable and climate-conscious practices.
5. Developing climate literacy to advise the business, including in respect of the mitigation of climate risks.
6. Seeking advice from specialised lawyers as required.

Despite the lack of guidance for in-house lawyers' duties in response to the climate crises, different organisations have started to raise awareness on this issue. Lawyers for Net Zero[16] and the Chancery Lane Project[17] are two initiatives that provide resources to in-house and private-practice lawyers to help them take action and navigate through the challenges brought about by climate change. This is in addition to the Law Society of England and Wales' new and growing resources webpage.[18]

4. Conclusion

In-house lawyers have a key role to play tackling climate change. They are both reputation guardians and trusted partners to many departments within an institution. In-house lawyers are often critical thinkers, who have the skillset to help identify and assess the importance of legal or regulatory risk emanating from climate change, and how to avoid and mitigate such risks.

More specifically, in-house lawyers in international organisations will need to include as part of their due diligence processes any impending policy, legal and regulatory changes in various jurisdictions that may give raise to climate risks (including transition or litigation risks). In-house lawyers can be *internal champions* by working with relevant departments to ensure the necessary level of granularity in their organisations' climate and sustainability strategy.

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[12] For an overview of the role of law and lawyers in delivering on the climate agenda, please see Strauss M., Boyd-Carpenter H, "The EBRD Climate and Sustainability Agenda: The Role of Law and Lawyers in Delivering on the Paris Agenda", Law in Transition Journal 2022.

[13] The Law Society of England, 'Practical Ways in-house lawyers can fight the climate crisis' <https://www.lawsociety.org.uk/topics/in-house/practical-ways-in-house-lawyers-can-fight-the-climate-crisis> accessed 3 November 2022.

[14] Usually defined to mean "*meeting the needs of the present without compromising the ability of future generations to meet their own needs*." United Nations, Report of the World Commission on Environment and Development's, 1987.

[15] ESG is far wider than the issue of climate change, and deserves a separate discussion, including the impact of a changing climate on human development and human rights.

[16] Lawyers for Net Zero, 'In-house counsel delivering climate action' <https://www.lawyersfornetzero.com/>, accessed 4 November 2022.

[17] The Chancery Lane Project, 'Start using climate aligned clauses in your contracts' <https://chancerylaneproject.org/>, accessed 4 November 2022.

[18] It is expected that the Law Society will publish in the next couple of months new guidance to the legal profession on what "climate-conscious" lawyering is. The Law Society of England, 'Climate Change' <https://www.lawsociety.org.uk/topics/climate-change/>, accessed 5 November 2022.

Looking at the “Tax” in ESG **through a Sustainable Investor Lens**

*Sandra Martinho**

Abstract: Until now, the Environmental, Social and Governance (“ESG”) legal framework has mainly concentrated around assessing and measuring environmental matters only. Yet, in recent times, taxes are no longer perceived as just a cost that businesses need to incur, but also as a measure to assess the contribution of businesses to society. Thus, taxes are now considered to play a key role in achieving the Sustainable Development Goals (“SDGs”). Against this background, this article explores the role of tax as an important component of the Governance in ESG, and discusses the role that Multilateral Development Banks (“MDBs”) can and should play in this sustainability journey.

The article reviews some of the recent international and European tax developments inspired by the principle of tax transparency and fair taxation, with a focus on the importance of tax good governance and how tax is slowly being integrated as part of ESG and sustainable reporting. It also reviews recent developments and initiatives taken by institutional investors and businesses to illustrate their commitment to responsible and sustainable investment, including on tax good governance matters. The article concludes with a discussion on the role that MDBs can and should play in this growing trend of good tax governance and responsible investment, and provides recommendations on how such institutions can promote that trend.

1. Introduction

Historically, taxes were not included as part of the discussions of the Environmental, Social, and Governance (“ESG”) agenda and, even less, considered to be a potential needed standard for the related ESG reporting framework.[1] This position changed over time and it is now acknowledged that taxes provide the domestic resources needed to deliver public services and investments, which will help to achieve the United Nations 2030 Sustainable Development Goals (“SDGs”). Thus, from being at the periphery of the ESG and sustainability goals, taxes are now seen by many stakeholders, notably by the United Nations (“UN”), as playing a vital role in achieving the SDGs and sustainable development in general.[2] They are no longer seen as a cost, but as an important measure to assess the contribution of businesses to society.

Indeed, corporate taxes are an important source of revenue for governments, without which governments

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The opinions expressed in this article are those of the author. They do not purport to reflect the opinions or views of the EBRD.

1 So far, the ESG focus has been on climate, biodiversity, and other environmental concerns; and is now moving on to consider social issues (like diversity, equity, and inclusion and worker wellbeing) and governance issues (like good standards for running a company, board composition and other corporate governance matters, as well as tax matters).

2 See resolution adopted by the General Assembly on 25 September 2015, “Transforming Our World: the 2030 Agenda for Sustainable Development”, https://www.un.org/en/development/desa/population/migration/generalassembly/docs/globalcompact/A_RES_70_1_E.pdf, cf. target 17.1: “*Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection*” (accessed 14 May 2022). For more details, please see also subsequent publications on this topic, e.g., “Follow-up note on the role of taxation and domestic resource mobilization in achieving the Sustainable Development Goals” (E/C.18/2019/2) available at https://undocs.org/E/C.18/2019/2 (accessed 14 May 2022). On how tax measures can support and/or undermine the achievement of the SDGs, see Pirlot, *A Legal Analysis of the Mutual Interactions between the UN Sustainable Developments Goals* (SDGs) & Taxation (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3467544 (accessed 14 May 2022).

will not be able to yield sufficient revenue to fund all the necessary public expenditures to promote and achieve the SDGs. If governments do not generate sufficient revenue from taxes, any shortfall will need to be funded by other means (like by issuing public debt). At times where public finances are considerably stretched after the post-2008 financial crisis, the recent COVID crisis and the current uncertain times of inflation, war and supply chain crisis, it is key to generate the necessary tax revenue. On this basis, it can be argued that tax systems can become more sustainable if measures are implemented against tax avoidance and aggressive tax planning, as such action would create additional tax revenue.[3] Yet, in the new sustainable world, we are all called to contribute in shaping such new world, namely by becoming more responsible and aware of the world we live in. This means that not only governments, but also individuals, companies, and investors have a role to play and need to contribute to help building this sustainable world, for which e.g., tax revenues are a very much needed financial resource.

Thus, as argued by Sonnerfeldt, "tax sustainability", can and should be considered, "*in the context of sustaining tax revenue of states through better governance and responsible tax payment by multinational companies*".[4] In a similar vein, Valsecchi, submits that "*corporate tax policies are going to play a key role in measuring the company's social impact: since paying taxes constitutes an indirect but utterly concrete way through which the company contributes to the prosperity of the society*".[5] Thus, the premise being that if companies do not pay their fair share of tax, such companies cannot be considered to be sustainable either. As put by Valsecchi, "*unfair tax policies – although formally compliant with the law – will be held by the stakeholders as undermining the universal challenge of sustainability*".[6]

Notwithstanding the above, the discourse about the role played by fair taxation in the pursuit of the SDGs, the UN 2030 and the ESG agendas have not yet been generally implemented by companies. In practice, this means that in most cases tax policies and related tax reporting still play little role – if any – in drawing sustainable business strategies and reporting on how a company's goals assist in fostering a more balanced and prosperous society.[7] Thus, for now, "Tax" remains outside of companies' ESG commitments, which, for the reasons mentioned above, should not be upheld.[8] Doing otherwise, i.e., by not including "Tax" as part of ESG, would mean that a company could be labelled as ESG-compliant and/ or sustainable, while being engaged in aggressive tax planning and therefore reducing its tax bill in a non-sustainable way (as without tax revenues, no SDGs can be achieved by governments of both developed and developing countries). As put by Sonnerfeldt, "*good governance and disclosures are purported as mechanisms to guide firms towards becoming sustainable companies, thus providing a link between tax and sustainability*".[9]

Against this background, this article explores the role of "Tax" as an important component of the "Governance" in ESG and discusses the role that Multilateral Development Banks ("MDBs") can and should play in this respect. The article recaps some of the recent international and European tax developments inspired by the principle of tax transparency, fair taxation and the need to restore confidence in the tax system, which served as a springboard to the growing importance of good tax governance (Section 2). It thereafter discusses the rationale and scope of a "Tax" standard as part of ESG and sustainable reporting (Section 3), as well as recent developments and initiatives taken by institutional investors and businesses to illustrate their commitment to responsible and sustainable investment, including on tax matters (Section 4). Building on the previous sections, Section 5 discusses the role that MDBs can play in this growing good tax governance and responsible investment trend, and makes recommendations on how MDBs can consider promoting and fuelling this trend. The article closes with some concluding remarks and recommendations to guide future actions (Section 6).

2. Recent International and European Tax Developments

As of 2016, the main drivers and goals of the work of the Inclusive Framework on Base Erosion and Profit Shifting (the "Inclusive Framework on BEPS") were to ensure fairness, coherence and transparency, and that taxation is aligned with where the actual economic activity takes place.[10] In addition, the work of OECD's Global Forum on

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[3] There are many economic studies from scholars and international institutions trying to estimate the loss on tax revenue by governments as a result of tax avoidance and aggressive tax planning practices by enterprises. The OECD "*conservatively estimated at around 4-10% of global corporate income tax revenues, or USD 100-240 billion annually; money that could be spent on education, health care, infrastructure, pensions*", cf. https://www.oecd.org/about/impact/ending-offshore-profit-shifting.htm (assessed on 10 September 2022).

[4] Sonnerfeldt, 'Towards Sustainable Taxation: Crossing Disciplinary Boundaries to Tackle Tax Avoidance More Effectively' in Cécile Brokelind and Servaas van Thiel (eds), *Tax sustainability in an EU and international context* (IBFD, Amsterdam 2020), p. 447.

[5] Valsecchi, 'What Corporate Tax Policy Has to Do with Sustainability and How Companies Should Deal with It' [2022] 14 (1) WTJ 113, 116.

[6] Ibid.

[7] Valsecchi, supra note 5, at 116-117.

[8] The same conclusion is reached by Klethi, who argues that an enterprise's tax strategy should be taken into account when assessing whether that enterprise meets the so-called ESG criteria. See Klethi, 'La prise en compte des stratégies fiscales agressives dans l'évaluation du respect par les entreprises des critères environnementaux, sociaux et de gouvernance' (2022) CFLE 25

[9] Sonnerfeldt, supra note 4, at 440.

[9] By way of background, in 2016, the OECD and G20 established the Inclusive Framework on BEPS to allow interested countries and jurisdictions to work with the OECD and G20 members to develop standards on BEPS related issues, and reviewing and monitoring the implementation of the fifteen measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment (i.e., BEPS package). Over 141 countries and jurisdictions have joined the Inclusive Framework on BEPS since then. The Inclusive Framework on BEPS continues to progress on its agenda, and is currently pushing for a global tax reform as set out in the OECD/ G20 BEPS 2.0 proposals, which is expected to be agreed before the end of 2022 or, at the latest, by mid-2023, for a phased entry into force in 2023 and 2024. The OECD/ G20 BEPS 2.0 proposals capture the so-called Pillar I and Pillar II rules, whose aim is to propose new measures to tackle the remaining BEPS risks identified. Pillar I aims to allocate taxing rights for cross-border activities based on revised nexus and profit allocation rules. Pillar II gives certain jurisdictions a right to tax undertaxed income where the income is taxed at an effective rate below a minimum rate (currently, expected to be fixed at 15%). Noting that the EU is closely following these developments and plans to implement Pillar I and II proposals within the EU in the form of two Directives (whose drafts for now remain to be approved by EU Member States as no consensus has been reached yet on any of such proposals).

Transparency and Exchange of Information for Tax Purposes (the "Global Forum")[11], which focuses on the reduction (and, ultimately, the end) of offshore tax evasion, supports countries in collecting taxes that would otherwise have been forfeited through opaque and unlawful cross-border arrangements.

Building on the Inclusive Framework on BEPS and the Global Forum's work, the European Commission also prepared a considerable amount of legislative proposals on tax transparency and tax good governance and, more recently, submitted a package for fair and simple taxation[12] to enable EU Member States secure the much needed tax revenues to promote and foster sustainable development. In relation to tax transparency, it is worth noting that, on 1 December 2021, the EU became the body to require public disclosure of income tax information by multinational enterprises ("MNEs"). The public country-by-country reporting ("CbCR") directive entered into force on 21 December 2021 and EU Member States are required to transpose this directive into national legislation by 22 June 2023.[13] Once the CbCR directive is transposed, then the rules will apply 12 months after the transposition deadline, which means that the first financial year of reporting on income tax information will be the year starting on or after 22 June 2024 at the latest (as Member States may also choose to apply the rules earlier). The first reports will be published within twelve months from the date of the balance sheet of the financial year in question. In practical terms this means that for calendar year taxpayers the first reportable year will be 2025, with the report due by the end of 2026.

In addition to the above-mentioned measures, on 22 December 2021, the European Commission released a proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes as part of their fair taxation for a sustainable recovery agenda.[14] The initiative was triggered by the impression on the part of the European Commission that entities set up in the EU with no or only minimal substance, performing no or very little economic activity, continue to pose a risk of being used for aggressive tax planning structures. Substance was always an important topic in international taxation when entities perform cross-border investment and business activities. However, the awareness about substance has only increased throughout the OECD/ G20/ Inclusive Framework on BEPS' work that focused on substance and transparency as two central topics. The proposed new measures will establish transparency standards around the use of shell entities, so that such abusive behaviour can more easily be detected and counteracted by tax authorities. Using objective indicators related to income, staff and premises, the proposal will help national tax authorities detect entities that exist merely on paper and to which tax advantages would be denied (i.e., shell entities would simply be disregarded for tax purposes).

Thus, the Inclusive Framework on BEPS project had a significant impact on the international and European tax landscape. In the EU, two EU Anti-tax Avoidance Directives (the so-called 'ATAD' and 'ATAD 2') have been adopted that require EU Member States to implement a number of anti-abuse provisions. Furthermore, bilateral tax treaties have been modified through the multilateral instrument on BEPS with a view to implement various anti-abuse provisions such as the principal purposes test. In addition, in order to increase transparency, a series of directives on administrative cooperation, the so-called 'DAC' series, were put in place. The latest, DAC 6, requires reporting of potentially aggressive transactions in corporate tax matters.

Hence, the tax authorities of EU Member States have been building up a comprehensive arsenal of anti-abuse rules that allow them to tackle abusive situations, and an efficient cooperation framework that should allow them to be aware of any residual tax avoidance or aggressive tax planning arrangements. This, in turn, should enhance tax transparency and fair taxation, and increase tax collection by tax authorities.

3. The Call for a "Tax" Standard as Part of ESG Reporting[15]

3.1 Introduction

Once one recognizes that the collection of the "fair share" of taxes is key in achieving SDGs, then the next natural step is to consider the impact that corporations and any other taxpayers may have on tax collection. Arguably, such impact may be positive or negative, depending on the tax behaviour of such taxpayers.

[11] With 165 members, the Global Forum is the leading international body working on the implementation of global transparency and exchange of information standards around the world. Since the G20 declared the end of banking secrecy in 2009, the international community has achieved great success in the fight against offshore tax evasion. In this respect, the Global Forum has served as the platform for countries to agree and implement robust standards that have prompted an unprecedented level of transparency in tax matters and to fight tax evasion. By doing so, it also contributed to the increase of the collection of taxes.

[12] The rationale and the measures for this package proposal can be found at: https://ec.europa.eu/taxation_customs/package-fair-and-simple-taxation_en (accessed 15 May 2022).

[13] See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2021:429:FULL&from=EN (accessed 15 May 2022). In a nutshell, the rules set forth in this directive will require both EU-based MNEs and non-EU based MNEs doing business in the EU through a branch or subsidiary with total consolidated revenue of more than EUR 750 million in each of the last two consecutive financial years to disclose publicly the income taxes paid and other tax-related information such as a breakdown of profits, revenues and employees per country. Such information needs to be disclosed for all 27 EU Member States and all jurisdictions included in the Annex I and Annex II of the Council conclusions on the EU list of non-cooperative jurisdictions for tax purposes. For all other jurisdictions, it is sufficient for aggregated data to be disclosed.

[14] For the EU's Unshell proposal text, background information and underlying rationale, please consult: https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_565_1_EN_ACT_part1_v7.pdf, https://ec.europa.eu/taxation_customs/taxation-1/unshell_en?pk_campaign=unshell&pk_source=twitter&pk_medium=social, https://ec.europa.eu/commission/presscorner/detail/en/ip_21_7027, and CbCR (all accessed 5 June 2022).

[15] For more details on this topic, see Sonnerfeldt, supra note 4, at 440-442; Valsecchi, supra note 5, at 117-121; and Klethi, supra note 8, as well as all the references referred therein by each of those authors.

It is in this context that good tax governance, and reporting thereon, appeared as a new element to be considered by a sustainable business. Thus, a sustainable-driven business is now expected to show that it has a sustainable footprint in tax matters too. In practice, this would imply, that a business needs to be transparent about its tax affairs so as to show that it is committed to and implements responsible tax practices, thereby paying its "fair share" of taxes in the countries it operates (instead of adopting aggressive tax practices which would lead to no or minimal taxes being paid in such countries and thereby could be considered as a form of tax avoidance behaviour[16]).

Thus, the departure point is to hold corporations accountable for their tax practices, which would then need to be assessed against the corporations' own sustainable strategy and commitments.

As pointed out by Sonnerfeldt:

> Notwithstanding the fundamental importance of the rule of law, legal and other scholars recognizing the limits of the current regulatory developments on tax avoidance have advocated corporate social responsibility (CSR) as a complementary mechanism in the vein of morals and ethics to foster responsible tax behaviour.[17]

In the next parts of this Section, the author will delve into some of the standards, metrics, and proposals which have been submitted in order to address the need to include "Tax" as part of ESG.[18]

3.2 The Development and Scope of the GRI 207: Tax 2019 Standard

In the regulatory arena, aside from the EU and intergovernmental organizations, a myriad of initiatives from non-governmental actors have appeared to foster more responsible tax behaviour as part of the wider agenda on ESG, corporate social responsibility ("CSR"), and sustainable reporting.

As regards specific standards on tax governance and reporting, one of the initiatives worth mentioning first is the one proposed by the Global Reporting Initiative ("GRI")[19], which is based on the double materiality principle.[20]

In 2019, GRI proposed the GRI Disclosures on Tax and Payment to Governments, i.e., the GRI 207: Tax 2019 standard for ESG purposes, which builds on the current GRI's sustainability reporting framework. This standard became applicable for GRI users (but only if a business (or organization) has identified tax matters as a material topic) for sustainability reporting on 1 January 2021 and sets expectations both on qualitative and quantitative tax disclosures.[21] While GRI 207: Tax 2019 is the first such tax reporting standard, others have been or are being developed, as it will be discussed in the next parts of this Section.

By way of background, from 2017-2019, an expert multi-stakeholder technical committee under the oversight of (and following the due process of) the Global Sustainability Standards Board, GRI's independent standard-setting body, developed the GRI 207: Tax 2019 standard. The latter was created in response to a call initially by US private equity investors, and over 250 other stakeholders, including businesses, investors, policymakers, civil society, labour organizations, and other experts, and who all provided input to this standard. Under GRI 207: Tax 2019, businesses are asked to gather and provide insights into four main areas: (a) approach to tax (or tax strategy); (b) tax governance, control, and risk management; (c) stakeholder engagement and management concerns related to tax; and (d) public CbCR tax data.[22]

In order to be consistent with the GRI 207: Tax 2019 standard, businesses are therefore expected to report, in particular, on their tax policy, their tax risk profile (by disclosing the use of tax havens, transfer pricing policy, tax incentives and any benefit from preferential tax treatment), the way in which tax affairs and control framework are governed and managed within the business, and detailed information on the level of tax payments per jurisdiction (including clarifications on differences between the effective tax rate incurred and the statutory corporate income tax rate if needed). In addition, if subject to CbCR, businesses are also expected to publicly disclose that information as part of the reporting due under this standard. Thus, quite a wide scope of tax transparency is required from businesses implementing GRI 207: Tax 2019 so that stakeholders and the wider society can carefully review and assess whether a businesses' approach to tax is sustainable.

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[16] The OECD's Glossary of Tax Terms, defines the term "Tax Avoidance" as follows: "*difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow*", cf. https://www.oecd.org/ctp/glossaryoftaxterms.htm.

[17] Sonnerfeldt, supra note 4, at 439 and references mentioned therein.

[18] See Valsecchi, supra note 5, at 18 and references mentioned therein, who clearly flags that while "*the need to communicate to the market has led to the proliferation of ESG ratings over the last years […], it is also acknowledged that ESG rating and sustainability reporting often fail to properly take into account tax-related factors*".

[19] GRI is one of the most important ESG standard setters that has pioneered sustainability reporting since 1997. While GRI was founded in the United States, it is now headquartered in Amsterdam with regional hubs around the world. Sustainability reporting based on the GRI Standards provides information about an organization's positive or negative contributions to sustainable development. It is important to note that GRI Standards cover a wide range of topics, such as social inclusiveness, water use, and human rights, and that such standards are voluntary and a free public good. It is understood that GRI standards are now used by more than 10,000 organizations around the world and that 75% of the largest 250 companies in the world use GRI's sustainability reporting framework. For more details, please consult: https://www.globalreporting.org/ (accessed 14 May 2022).

[20] The concept of 'double-materiality' was first formally proposed by the European Commission in 2019, requiring companies to report about (i) how sustainability issues affect the development, performance, and position of their own business; and (ii) the environmental and social impact of their own business activities.

[21] In this respect, it worth noting that a growing number of companies are already voluntarily reporting with GRI 207: Tax 2019 Standard, such as Allianz, Anglo American, BP, Credit Suisse, Deutsche Bank, Enel, Lukoil, Nestlé, NN Group, Novartis, Orsted, Phillips, Publicis Groupe, SAP, Swiss Re, UBS, Unibanco, Visa, Volkswagen, and Zurich Insurance.

[22] The GRI 207: 2019 Tax Standard is freely available at https://www.globalreporting.org/standards/media/2482/gri-207-tax-2019.pdf (accessed 14 May 2022).

As pointed out by GRI[23] itself and by some scholars, the rationale for such a wide scope of transparency and reporting on tax matters by companies seems to be underpinned by the idea that more transparency will lead to good tax behaviour and thereby making companies pay their "fair share" of tax:

> firms [are require] to publicly report their tax policy, the tax incentives taken and tax payments based on the notion that transparency would serve as a sword against aggressive tax planning. Transparency has a somewhat mythical status and is associated with good governance.[24]

> Indeed, the rationale at the basis of the new standard is that corporate tax policies aimed at minimizing tax obligations on the one hand have a direct impact on the government's effort to improve public services, and on the other hand affect the way in which tax burdens are distributed among all the taxpayers, hence they eventually undermine the entire tax system on a higher scale by triggering a domino effect which leads to other players enacting aggressive tax policies to prevent a potential competitive disadvantage: this is why, in the perspective of developing a more sustainable business environment, stakeholders have to be put in a position of being able to assess the fairness of companies' tax strategies.[25]

3.3 Other "Tax" Standards

Following the footprints of GRI 207: Tax 2019, other "Tax" standards or ESG metrics have been proposed and others are likely to follow soon. These are discussed below, to highlight the keen interest on tax metrics and reporting as part of the ESG/sustainability framework.

The World Economic Forum ("WEF") has developed its own ESG metrics, and in its final proposal requires businesses to disclose total tax paid, tax remitted, and total and additional tax breakdown by country for significant locations.[26] Although WEF's proposed tax reporting is much narrower than the scope of the GRI 207: 2019 Tax standard, the latter had interestingly been included in WEF's first draft as the tax standard to be endorsed.[27] Yet, it seems that ultimately endorsing the transparency of CbCR information as part of the sustainability reporting might have been one of the main limiting factors for the endorsement.[28] It is therefore reasonable to conclude, that while businesses were not keen on voluntarily endorsing the broad scope of tax disclosures included in GRI 207: Tax 2019, the latter played a key role in triggering the development of the WEF's tax metrics as a new component of sustainable reporting.

Similarly, NGOs and other European and international organizations or bodies have also been leading a civil society movement towards the inclusion of tax matters as part of the ESG/sustainability agendas. The most recent proposal was the civil society proposal for a United Nations Convention on Tax (the "UN Tax Convention") launched in March 2022 by the European Network on Debt and Development (Eurodad) and the Global Alliance for Tax Justice (GATJ). According to these organizations, their proposal responds to strong concerns that have been raised regarding the existing international tax system. Their proposal also integrates several ideas for reforms advanced by governments, civil society organisations, international experts and several UN high-level panels, including the High Level Panel on International Financial Accountability, Transparency, and Integrity for Achieving the 2030 Agenda ("FACTI Panel").[29]

The UN Tax Convention has as objective to ensure tax systems are transparent, equitable, and effective. It also includes explicit focus on the role of taxes in safeguarding human rights, environmental protection, and supporting the SDGs. In relation to tax matters, there are similarities between the content of the GRI 207: Tax 2019 Standard and some of the content of the proposed UN Tax Convention; namely Article 7 on public CbCR, Article 8 on transparency around tax policies and practices, and Article 9 on transparency standard.[30]

While the scope and content of tax reporting is far from being harmonized, certain recent cooperation and

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[23] Ibid. (in particular, please refer to part D. of the introduction providing the background context for this standard, as well as the detailed guidance provided for each of the required tax disclosures).

[24] Sonnerfeldt, supra note 4, at 440-441 and references mentioned therein. The author notes, however, that while this premise seems to be widely accepted, empirical evidence measuring its positive effect is still missing. Thus, it remains to be seen whether public tax transparency will really trigger responsible taxpayer behaviour or whether it will become a pure compliance exercise for companies with no real transformation or change towards responsible tax behaviour.

[25] Valsecchi, supra note 5, at p. 121.

[26] WEF, *Measuring Stakeholder Capitalism Towards Common Metrics and Consistent Reporting of Sustainable Value Creation*, White Paper (2020), 10-78. This WEF final paper can be freely retrieved at: https://www3.weforum.org/docs/WEF_IBC_Measuring_Stakeholder_Capitalism_Report_2020.pdf (accessed 14 May 2022).

[27] WEF, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, Consultation Draft (2020), 9, 27, and 39. This WEF draft paper can be freely retrieved at: https://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf (accessed 14 May 2022). It was prepared in collaboration with Deloitte, EY, KPMG and PwC.

[28] For completeness, it is important to note that, while the GRI 207: Tax 2019 calls for Action 13 - CbCR information to be made publicly available by businesses, this does not mean that between them there are no differences in their personal and material scope. Notably, GRI 207: Tax 2019 is a voluntary public disclosure for a business or organization of any size, type, sector or geographic location that identifies taxes as material to be reported on; whereas BEPS Action 13 – CbCR is mandatory for MNEs with consolidated group revenues of more than EUR 750 million. Cf. GRI, *Comparison of GRI 207: Tax 2019 & OECD Action 13 BEPS CbCR* https://www.globalreporting.org/standards/media/2537/comparison-gri-207-tax-2019-oecd-beps.pdf (accessed 14 May 2022).

[29] By way of background, in accordance with Eurodad's press release, "the call to develop a UN Tax Convention was first put forward by the Africa Group at the United Nations in 2019. The following year, it was included in a 'Menu of Options' produced as part of a UN process to consider how the international community could respond to the Covid-19 crisis", cf. https://www.eurodad.org/un_tax_convention_press (accessed 15 May 2022). Subsequently, in February 2021, the FACTI Panel issued its report with 14 recommendations to reform, redesign and revitalize the global architecture, so it can effectively foster financial integrity for sustainable development, which included e.g., the proposal for the initiation of an UN Tax Convention and called for more tax transparency and fairness by MNEs. See, in this respect, in particular, "Recommendation 2: Legitimacy, Recommendation 3: Transparency and Recommendations 4 and 5: Fairness". The full report can be retrieved at: https://uploads-ssl.webflow.com/5e0bd9edab846816e263d633/602e91032a209d0601ed4a2c_FACTI_Panel_Report.pdf (accessed 15 May 2022). For more details on the work of the FACTI Panel, see: https://www.factipanel.org

[30] The UN Tax Convention can be retrieved at https://assets.nationbuilder.com/eurodad/pages/2852/attachments/original/1654678410/un-tax-convention-final.pdf?1654678410 (accessed 15 May 2022).

collaboration initiatives may pave the way for a more harmonized tax standard in the near future. In this respect, the collaboration agreement announced on 24 March 2022 between the International Financial Reporting Standards ("IFRS") Foundation and GRI is worth mentioning.[31] These two bodies will seek to coordinate their work programmes and standard-setting activities, which is a welcome development in a still rather fragmented landscape.

3.4. EU Developments towards a "Tax" Standard and Metrics

At the EU level, there are also some developments on the consideration and inclusion of a "Tax" standard and metrics within the framework of sustainable reporting. Yet, as highlighted below, even at the EU-level, there is still a lot to be done to achieve harmonization in this area. In order to contextualize EU developments in this area, this article will now review a couple of recent initiatives.

On 22 June 2020, the Regulation on the establishment of a framework to facilitate sustainable investment was published in the Official Journal (the "Taxonomy Regulation").[32] The Taxonomy Regulation establishes a classification system (or taxonomy) which provides businesses with a common language to identify whether a given economic activity should be considered 'environmentally sustainable'. This, then, allows it to be determined how far an investment is environmentally sustainable too. Thus, the aim of the Taxonomy Regulation is to establish a transparency and uniform tool that facilitates decisions on investment and helps tackle greenwashing by providing a categorisation of environmentally sustainable investments in economic activities that also meet minimum social safeguards.[33] Thus, for the purposes of establishing the degree to which an investment is 'environmentally sustainable', an economic activity shall qualify as 'environmentally sustainable' where that economic activity is carried out e.g., in compliance with the minimum safeguards laid down in Article 18(1) of the Taxonomy Regulation, one of which is to ensure alignment with the OECD Guidelines for Multinational Enterprises (the "OECD MNE Guidelines").[34] The OECD MNE Guidelines cover a series of topics and recommendations for multinational enterprises ("MNEs") regarding their responsible business conduct in a global context, including on taxation matters. As noted by the OECD in the preface to this document, the OECD MNE Guidelines:

> aim to ensure that the operations of these enterprises are in harmony with government policies, to strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises.[35]

On 21 April 2021, the European Commission submitted a proposal for a Corporate Sustainability Reporting Directive ("CSRD"), which envisages the adoption of EU Sustainability Reporting Standards ("ESRS").[36] The CSRD sets out what and how companies which meet two of the following three characteristics have to disclose on sustainability matters: more than 250 employees, a turnover of over EUR 40 million, and a balance sheet of more than EUR 20 million.[37] For SMEs (not micro enterprises) with securities listed on EU Regulated Markets lighter disclosure requirements will apply. The CSRD incorporates the concept of "double materiality" too and thereby covers both risks and opportunities for the companies, as well as for people and the environment. Companies within the scope of the CSRD do not only have to publish certain sustainability information, but this information will also be audited and presented in a digital format. Thus, in order to achieve its goals, the CSRD will rely on ESRS disclosure requirements (final drafts still to be released), whose aim is to improve comparability, availability, and quality of corporate sustainability-related information. In practice, for investors, this means that, in the near future, a more reliable basis of data for the assessment and comparison of the sustainability of companies will be available. While this legislative process is still ongoing, the goal is to finalize the ESRS and request the relevant sustainability reports to be produced on or after 1 January 2025.

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[31] See https://www.globalreporting.org/about-gri/news-center/ifrs-foundation-and-gri-to-align-capital-market-and-multi-stakeholder-standards/ (accessed 15 May 2022).

[32] Regulation (EU) No. 852/2020 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) No. 2088/ 2019, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN (accessed 10 September 2022).

[33] For completeness, it is noted that the Taxonomy Regulation is a major building block of the wider EU regulations and directives of market participants and products with respect to sustainability matters, which aside from the draft European Directives that will be covered in this Section, also includes the Sustainable Finance Disclosure Regulation ("SFDR"), which will not be discussed in this Section. The SFDR was enacted by the Regulation (EU) No. 2088/2019 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, whose consolidated version is available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R2088&qid=1663263797567 (assessed 10 September 2022). The SFDR, obliges financial market participants to disclose social and environmental aspects on both entity (for example, asset manager) and financial product (for example, fund level). More concretely, requirements under SFDR relate to three key concepts: a) sustainable investment, b) sustainability risk, and c) sustainability factors. Given that, the Taxonomy regulation in its Article 18(2) introduces a direct link between the minimum safeguards of the Taxonomy Regulation and the SFDR, the practical implication is that if certain minimum safeguards would need to be complied with under the Taxonomy Regulation, then the same would apply under the SFDR too.

[34] The OECD MNE Guidelines have been last revised by the OECD in 2011 (next review expected in 2023-2024), and are available at https://www.oecd.org/daf/inv/mne/48004323.pdf (accessed 10 September 2022).

[35] OECD MNE Guidelines, supra note 34, at p. 13. The same idea is expressed in other parts of the OECD MNE Guidelines, which e.g., at p. 60 clearly states the importance "*that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate*".

[36] See "*Proposal for a Directive of the European Parliament and of the Council*" amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (COM/2021/189 final), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189 (accessed 15 May 2022).

[37] Noting that ultimately the CSRD also wants to have a non-EU reach as non-EU undertakings with annual EU-generated revenues in excess of 150 million euros and which also have either a large or listed EU subsidiary or a significant EU branch (generating 40 million euros in revenues), then such EU entity (belonging to a non-EU undertaking) would be responsible for publishing CSRD-style sustainability reports for these non-EU undertakings at a consolidated level from 2028 onwards.

Subsequently, on 23 February 2022, the EU Commission published a draft Directive on Corporate Sustainability Due Diligence ("CSDD").[38] The CSDD will also have an EU and non-EU reach, albeit with a different and much more complex subjective scope than the CSRD.[39] According to the European Commission:

> The aim of this [CSDD] Directive is to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance. The new rules will ensure that businesses address adverse impacts of their actions, including in their value chains inside and outside Europe.[40]

Now that the different European developments in the area of sustainability have been reviewed, the next questions that are relevant for this paper are whether: (a) the Taxonomy Regulation covers the topic of taxation as one of the minimum safeguards; (b) CSRD and the related ESRS will provide for tax-related disclosures as part of the corporate sustainability information that should be provided by the in-scope companies; and (c) new due diligence rules will require tax-related due diligence to be carried out by the in-scope companies.

As regards the Taxonomy Regulation, besides the above-mentioned call for harmonization of standards, various elements of the GRI 207: Tax 2019 Standard have arguably inspired, and can be found in, other recent ESG/ sustainability publications at the EU level, for example in the final advice prepared by the Platform on Sustainable Finance regarding the EU Social Taxonomy. The latter document includes different tax matters as part of governance topics directly linked to sustainability, such as transparent and non-aggressive tax planning, tax transparency and tax approach. It also includes other non-tax matters, such as anti-bribery, anti-corruption, and whistle-blowing, responsible lobbying and political engagement, diversity of board members and the option of employee representation on supervisory boards.[41] Subsequently, in July 2022, the Platform on Sustainable Finance released their draft report on the minimum safeguards required by the Taxonomy Regulation. In the same vein, this draft report has clearly confirmed that taxation is a substantive topic which remains pertinent to minimum safeguards and has further elaborated on its exact content.[42] Thus, building on the OECD MNE Guidelines, which cover the topic of taxation, the Platform on Sustainable Finance provided further guidance on the non-alignment criteria recommended on this topic, as follows:

> This two-dimensional assessment of MS [i.e., minimum safeguards in relation to Articles 3 and 18 of the Taxonomy Regulation] alignment directly flows through to the proposed two recommended criteria for alignment with minimum safeguards:
>
> 1. The company does not treat tax governance and compliance as important elements of oversight, and there exists no adequate tax risk management strategies and processes as outlined in OECD MNE Guidelines covering tax.
> 2. The company has been finally convicted of tax evasion. In the future it might be necessary to further qualify the kind of court cases.
>
> If one of the two criteria applies to an undertaking, it should be considered not compliant with MS. The status of non-compliance should be upheld until the company has proven that its processes have been improved in a way that a repetition of breaches is unlikely.
>
> An undertaking that fails to meet one or more of the criteria should not be considered compliant or in compliance with MS.[43]

The report also clarifies that tax compliance should be interpreted broadly as there is an "e*merging understanding of tax compliance is no longer limited to tax evasion, but also includes tax avoidance through aggressive tax planning*".[44] Considering, however, that the main reference document, i.e., the OECD MNE Guidelines, is quite old and outdated, the Platform on Sustainable Finance further states that "*the endorsement of standard GRI 207: Tax 2019 is recommended as an indicator of an undertaking's more ambitious understanding of tax fairness*".[45]

As regards the CSRD and the ESRS, one needs to look at the work done so far by the European Financial Reporting Advisory Group ("EFRAG")[46], as the latter's goal is to design and draft the relevant sustainability reporting

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[38] See "*Proposal for a Directive of the European Parliament and of the Council*" amending Directive 2019/1937/ EU, as regards corporate sustainability due diligence (COM/2022/71 final), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071&qid=1663170568093 (accessed 10 September 2022).

[39] She CSDD applies to EU and non-EU companies falling under the so-called 'Group 1' and 'Group 2'. 'Group 1' comprises all EU limited liability companies of substantial size and economic power (with more than 500 employees and more than 150 million euros in net turnover worldwide); and 'Group 2' comprises other limited liability companies operating in defined high impact sectors (e.g., textiles, agriculture, extraction of minerals), which do not meet both 'Group 1' thresholds, but have more than 250 employees and a net turnover of 40 million euros worldwide and more. For non-EU companies, the CSDD will only apply if such companies are active in the EU, and have a turnover threshold aligned with 'Group 1' and 'Group 2', which in both cases should be generated in the EU.

[40] See https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en (accessed 10 September 2022).

[41] See, *Final Report on Social Taxonomy* prepared by the Platform on Sustainable Finance in February 2022, which can be retrieved at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf at pp. 7, 30, 45, 61, 64, and 66-67 (accessed 14 May 2022).

[42] See, Draft Report on Minimum Safeguards prepared by the Platform on Sustainable Finance in July 2022, which can be retrieved at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/draft-report-minimum-safeguards-july2022_en.pdf at pp.3-4, 8-9, 12, 14, 16, 21-22, 24-25, 27-28, 30-31, 45-47, 49-50, and 57-58 (accessed 10 September 2022).

[43] See Platform on Sustainable Finance, supra note 42, at p. 46. See also the summary of the criteria for minimum safeguards alignment on the topics of taxation and other governance topics on pp. 57-58.

[44] See Platform on Sustainable Finance, supra note 42, at p. 46.

[45] Ibid.

[46] EFRAG is the body responsible for advising the European Commission and setting ESG standards and mandatory sustainability standards in Europe.

standards in order to "ensure that information is comparable and that all relevant information is disclosed"[47], and to introduce a general assurance requirement for reported sustainability information. In this context, in May 2021, GRI was invited to participate in the European Commission's High-Level Conference on the CSRD's proposal at which Executive Vice-President Dombrovskis and Commissioner McGuiness highlighted the importance of international convergence between European and global sustainability reporting standards. Following this call for cooperation, on 8 July 2021, GRI and EFRAG signed a cooperation agreement, which hopefully will enable these two standard setters to make progress on the harmonization of sustainability reporting, including potentially on tax reporting.[48]

Yet, surprisingly, "Tax" was not included as part of the proposed governance standards in the Draft ESRS released by EFRAG, on 29 April 2022 for public discussion until 8 August 2022. In relation to governance standards, the Draft ESRS proposes 2 topical standards:[49]

- 'ESR G1 - *Governance, risk management and internal control*', which will cover ten disclosure requirements on (a) governance structure and composition, (b) corporate governance code or policy, (c) nomination process, (d) diversity policy, (e) evaluation process, (f) remuneration policy, (g) risk management processes, (h) internal control processes, (i) composition of the administrative, management and supervisory bodies and (j) meetings and attendance rate; and
- 'ESRS G2 - *Business conduct*', which will cover ten disclosure requirements on (a) business conduct culture, (b) policies and targets on business conduct, (c) prevention and detection of corruption and bribery, (d) anti-competitive behaviour prevention and detection, (e) anti-corruption and anti-bribery training, (f) corruption or bribery events, (g) anti-competitive behaviour events, (h) beneficial ownership, (i) political engagement and lobbying activities and (j) payment practices.

Now, the author was not the only one to be surprised, the Platform on Sustainable Finance was surprised too. Indeed, in its July report, the Platform on Sustainable Finance pointed out quite fiercely that the narrow scope of the ESRS that had been proposed so far by the EFRAG needs to be reconsidered, as follows:

> Concerning the topics stemming from Article 18, the CSRD makes some explicit statements on the scope of required disclosure on human rights, anti-bribery, and corruption. The Draft ESRS Exposure Drafts on the topical European Sustainability Reporting Standard (ESRS) G3 also covers anti-competitive behaviour. **However, taxation is not explicitly mentioned so far in the EFRAG work** [author's emphasis]. **It is, however, expected that the ESRS will provide investors with information to evaluate the adequacy of tax strategies and risk processes of a company** [author's emphasis]. This is due to the stipulation in the OECD MNE guidelines that tax matters are to be considered "important matters of board oversight and risk management". **Tax matters are also addressed in other EU regulations, and in the definition of 'sustainable investment' in the SFDR**[50] [author's emphasis].[51]

On this basis, it seems plausible to conclude that the Platform on Sustainable Finance considers that a company to be labelled as sustainable needs to show that it contributes to society by paying its "fair share of tax" and, in their view, this is required by the OECD MNE Guidelines, which should apply both to the Taxonomy Regulation and CSRD (together with the related ESRS).[52]

It follows from the above that, at this stage, tax reporting has not been included as part of the disclosure requirements of the Draft ESRS related to the CSRD. That said, it remains to be seen whether tax reporting will be included (or not) as part of the final version of the CSRD and related ESRS. In the author's opinion, the ESRS might still be amended in light of the comments to be received under the open consultation process or to take into account other recent EU publications in which inclusion of tax matters as part of the sustainable finance agenda was considered appropriate. In this context it is important to consider the above-mentioned final advice and draft report on minimum safeguards prepared by the Platform on Sustainable Finance regarding the EU Social Taxonomy which included and discussed at length the need to include a "Tax" standard and tax metrics as part of the good governance standards.[53]

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[47] See https://www.efrag.org/EuropeanLab/LabGovernance/44/European-Lab-PTF-on-preparatory-work-for-the-elaboration-of-possible-EU-non-financial-reporting-standards-PTF-NFRS (accessed 15 May 2022).

[48] See https://www.globalreporting.org/about-gri/news-center/gri-welcomes-role-as-co-constructor-of-new-eu-sustainability-reporting-standards/ (accessed 15 May 2022).

[49] As explained in the *Cover Note to the Draft ESRS*, "the governance topical standards aim at prescribing disclosure requirements pertaining to governance aspects, as sustainability matters *per se* (i.e., not limited to governance of sustainability matters), like business ethics and conduct, Board diversity and inclusion", cf. https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FESRS_CN.pdf at 9 (accessed 15 May 2022). For the two governance topical standards, see Appendix I to the Draft ESRS, available at: https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FED_ESRS_AP1.pdf at 2-3 and 11 (accessed 15 May 2022).

[50] See supra note 33.

[51] Platform on Sustainable Finance, supra note 42, at p. 14. As explained at p. 13 of the same report, as a result of the interaction between the minimum safeguards of the Taxonomy Regulation and the SFDR, in order to be considered as a "sustainable investment" in the sense of SFDR, it would be required that "*investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff, and tax compliance*".

[52] See Platform on Sustainable Finance, supra note 42, at p. 46 providing that "*it can reasonably be concluded that tax matters are to fall under "sustainability impacts, risks and opportunities", which makes them reportable under ESRS and will allow investors to form a view on an undertaking's self-assessment of MS-alignment*".

[53] For completeness, it is worth noting that the topic of corporate social responsibility and taxation is also being considered by the EU in different fora. For example, on 15 June 2021, the European Commission presented a paper on "Sustainable Finance and Taxation" to the Platform for Tax Good Governance. The role of the latter body is to assist the Commission in developing initiatives to promote good governance in tax matters in third countries, to tackle aggressive tax planning and to identify and address double taxation. For more details, see: https://ec.europa.eu/taxation_customs/system/files/2021-06/20210615_sustainable_finance_and_tax.pdf for the paper and, for the minutes of this meeting, see: https://ec.europa.eu/taxation_customs/system/files/2021-09/2021%2006%2015%20Summary%20Record.docx.pdf (both documents accessed 21 May 2022).

As regards the CSDD and related due diligence reporting obligations, for now the reply should be negative as the OECD MNE Guidelines are not covered in the draft proposal. Yet, considering the interplay between all the EU legislative initiatives, it remains to be seen whether the draft CSDD will be amended to cover due diligence reporting obligations by reference to the OECD MNE Guidelines.[54]

Notwithstanding the above lack of harmonization, the call for more tax transparency and inclusion of a "Tax" standard as part of sustainable reporting has wide acceptance. Hence, the next Section discusses recent developments and initiatives taken by institutional investors and businesses to illustrate their commitment to responsible and sustainable investment, including on tax matters.

4. The Growing Interest in Tax-related matters in ESG and beyond

While it took a long time to have a tax standard for ESG reporting, it is clear that there is currently a strong interest in tax matters from different fronts. Tax is now considered a material element which should be part of the ESG agenda as well as of the sustainable and responsible investment agendas. Having said that, the manner and extent to which tax matters should be taken into account and reported on is still work in progress.

At this point, it is important to discuss what actions different stakeholders, particularly institutional investors, have been recently taking in order to include "Tax" as part of their sustainable assessment. MDBs ought to take this into account in order to develop and solidify their position in this new space.

In this respect, a couple of interesting initiatives and recent developments embedding tax matters in the responsible investors' agenda are discussed below:

- *Principles for Responsible Investment ("PRI")* – PRI is an independent body, which is supported by the United Nations, and is the world's leading proponent of responsible investment. Currently, PRI has almost 5,000 signatories.[55] PRI's main goals are to (a) understand the investment implications of ESG factors, and (b) support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. In relation to tax matters, 'tax strategy' is included as one of the ESG factors to be taken into account by responsible investors.[56] PRI also considers that the lack of corporate disclosures on tax issues is a key impediment for investors that want to understand companies' positions on tax issues and assess tax risks in their portfolio. Against this backdrop, PRI has been focusing on how to assist investors to assess tax risks in their portfolio, thereby advancing tax transparency and tax fairness.[57] Moreover, in PRI's 2021-2024 strategic plan, tax fairness is included as part of the governance programme,[58] underscoring the fact that PRI considers the inclusion of taxes as part of the ESG agenda and sustainable or responsible investment reporting a key priority.[59]
- *Norges Bank Investment Management* – Norway's sovereign wealth fund follows an ethical framework endorsed by the Norwegian Parliament to guide and monitor its investments. An important document in their tax regime is the "Expectation document on tax and transparency", which outlines Norway's sovereign wealth fund's expectations towards companies on tax and transparency matters.[60] This expectation document is underpinned by the following three main principles: (a) taxes should be paid where the companies' economic value is generated; (b) all tax arrangements entered into by a company are the responsibility of its board of directors; and (c) public CbCR is a core element of transparent corporate tax disclosures. This raises the question of whether the declaration of principles led to an active ownership and effective impact on the portfolio, which seems to have been the case. Indeed, in 2021, Norway's sovereign wealth fund announced that it had dropped several investments in companies due to lack of tax transparency or aggressive tax planning.[61] This was quite an important milestone in this area because, for the first time, the investee company's tax behaviour was considered as part of the decision to keep or sell an investment.[62]
- *Tax Code of Conduct* – Danish pension funds, together with certain Danish foundations and associations, have also adopted the pension sector's Tax Code of Conduct.[63] The role of this Tax Code of Conduct is to set principles and recommendations for responsible tax behaviour regarding unlisted investments

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[54] The interplay between the different EU initiatives in the area of sustainability and, in particular, between the minimum safeguards required by Article 18 of the Taxonomy Regulation and the draft CSDD are expressly refereed in the explanatory memorandum to the draft CSDD. See CSDD, supra note 38, at p. 5.

[55] https://www.unpri.org/signatories/signatory-resources/signatory-directory (accessed 21 May 2022). Noting that several MDB's are PRI's signatories, like the EBRD and the IFC.

[56] See, e.g., p. 4 of the PRI's 2021 brochure available at: https://www.unpri.org/download?ac=10948 (accessed 21 May 2022).

[57] For a review of PRI's publications in the field of tax, see https://www.unpri.org/sustainability-issues/environmental-social-and-governance-issues/governance-issues/tax-fairness (accessed 21 May 2022).

[58] See https://www.unpri.org/download?ac=13269 (accessed 21 May 2022).

[59] Thus, arguably, reporting in accordance with GRI - 207 for example also allows organizations to address the needs of responsible investors as set in the UN PRI guidance.

[60] See the relevant document at: https://www.nbim.no/contentassets/48b3ea4218e44caab5f2a1f56992f67e/expectations-document---tax-and-transparency---norges-bank-investment-management.pdf (accessed 21 May 2022).

[61] See the press release at: https://www.reuters.com/world/europe/first-time-norways-wealth-fund-ditches-firms-over-tax-transparency-2021-02-01/ (accessed 21 May 2022).

[62] See also the inclusion of tax matters in their Responsible Investment Report released for the 2021 financial year, which is available at: https://www.nbim.no/contentassets/950222269756407898cadb999926c16c/gpfg-responsible-investment-2021-web.pdf (accessed 21 May 2022).

[63] See https://www.pensiondanmark.com/globalassets/dokumenter/investering/new-tax-code-of-conduct.pdf (accessed 21 May 2022).

made via external asset managers. The core tax principles of the Tax Code of Conduct are as follows: (a) no tolerance to aggressive tax planning; (b) encourage external asset managers to adopt their own tax policies and to monitor and manage relevant tax-related risks responsibly; (c) encourage transparency concerning taxes; and (d) rights to monitor or request additional reporting to verify that external asset managers are not practicing aggressive tax planning.

The three examples above illustrate the growing interest and concern of responsible investors towards tax, but also the plethora of different initiatives in this space and the need for additional work and streamlining. Notwithstanding the diversity and the need for additional work, some common ground also surfaces from the above initiatives. Notably, promoting or ensuring that investments portray a responsible corporate approach to tax practices, including better disclosure and transparency, good governance, and appropriate management of tax-related risks.[64] By doing so, it is considered that responsible investors will be able to identify 'toxic assets' against the tax metrics developed to assess their investments' portfolio. Similarly, by having a clear expectation document, code or guidelines as regards tax transparency or tax fairness matters, these responsible investors will also be able to support and promote the endorsement of good tax governance practices by their investee companies. On the other hand, failing to adhere to such tax standards (e.g., when aggressive tax behaviour or lack of tax policies or insufficient tax transparency would be identified) should prompt responsible investors to actively engage with such companies with poor tax governance practices and, if needed, exit from such investments.

A somewhat different but related development is the growing self-commitment or self-engagement in tax governance by the companies themselves. Companies are taking the initiative to include tax as part of their sustainable policies with a view to enhancing their tax transparency and corporate social responsibility. To illustrate this new trend, the following recent developments are considered:

- *The B Team* – This global initiative, officially launched under the name the "B Team's Responsible Tax Principles"[65] at the Tax & SDG Conference at the United Nations Headquarters in New York in February 2018, has continued to work and to make concrete proposals regarding responsible taxation.[66]
- *New annual reports covering tax transparency/tax disclosures* – A growing number of companies now issues annual reports providing an overview of the taxes they paid across jurisdictions, their approach to tax, and other items. These reports have different names and scope, such as total tax contribution reports, tax transparency reports or sustainable reports reflecting GRI-207 or other narrower tax reporting standards (such as the one proposed by the WEF) (see Sections 3.2 and 3.3 above).[67]
- *Release of good tax governance publications by companies' associations or industries* – In this respect, two recent publications are worth mentioning: the release of the paper "*Best Practices for Good Tax Governance*"; and the new "*Tax Governance Code*" in the Netherlands.

  > Building on the discussions over the last few years among tax directors who are members of the following three organisations, the Tax Executives Council of the Conference Board, The B Team and the European Business Tax Forum, the paper "Best Practices for Good Tax Governance" was released in May 2022.[68] As acknowledged by their authors, the paper was triggered by the public debate about 'aggressive tax planning', fair taxation and the need for international tax reform, which appeared to show a lack of trust and understanding as to how MNEs approach taxes and their associated risks. For these organisations, it also became apparent that, while individual MNEs have developed processes to improve tax risk management and controls, there is still no common standard or established best practice on good tax governance and related reporting thereon. Furthermore, it is now widely acknowledged that a range of internal and external stakeholders expect to be provided with better information on how MNEs manage risks, including taxation.

  > In May 2022, the Confederation of Netherlands Industry and Employers presented a new "Tax Governance Code", which was immediately endorsed by more than 40 major Dutch MNEs[69], and which is expected to be further endorsed by more MNEs in the near future.[70] The goal of the "Tax Governance Code" is to

[64] Not surprisingly these parameters were also recently proposed by the Platform on Sustainable Finance as the criteria that a sustainable business needs to comply with regarding tax matters. I.e., companies should include tax governance and compliance as part of management's oversight, and should have adequate tax risk management strategies and processes. See supra Section 3.4., and Platform on Sustainable Finance, supra note 42.

[65] A group of companies operating under the banner "The B Team" is advocating adherence to a series of responsible tax principles that may serve to demonstrate their corporate responsibility and help create a more stable, secure and sustainable society, cf., https://bteam.org/assets/reports/A-New-Bar-for-Responsible-Tax.pdf (accessed 21 May 2022). This could also encourage more dialogue between corporates and tax authorities, thereby facilitating a mutual trust relationship. The B Team responsible tax principles essentially encourages businesses to (i) make boards accountable for tax policy, (ii) publish a tax strategy and be transparent about its implementation, (iii) be transparent about the entities owned within the corporate group around the world and why, and (iv) provide information on the company's overall effective tax rate, and on the taxes paid where they do business.

[66] For an overview of The B Team's work in this area, see: https://bteam.org/our-work/causes/governance/advancing-responsible-tax-practice (accessed 21 May 2022).

[67] For an annual study and analysis of the total tax contribution reports of the largest companies in the EU, EFTA and the UK, see: https://ebtforum.org/ttc/.

[68] For the paper and more background information on this initiative, see: https://ebtforum.org/good-tax-governance/ (accessed 21 May 2022).

[69] The companies that have endorsed this New Tax Governance Code include Philips, Corbion, Adyen, SHV, Aegon, Prosus, Jumbo Supermarkten, Ahold Delhaize, Randstad, Royal A-ware Food Group, Akzo Nobel, Shell, Faber Group, ASM International, Unilever, Rabobank, ASML, Wolters Kluwer, Achmea, a.s.r., ABN Amro, NXP, DSM, Fugro, BAM, Heineken, PostNL, Ordina, ING, TomTom, Arcadis, KPN, Van Lanschot Kempen, NN, Vopak and KLM.

[70] For more details on the highlights and full text of the Tax Governance Code (in English and Dutch), see: https://www.vno-ncw.nl/taxgovernancecode (accessed 21 May 2022).

> lead to more transparency on the tax position of Dutch listed companies and, by doing so, help to build trust. The "Tax Governance Code" builds on existing transparency initiatives and is based on the 'comply or explain' principle. To meet the ambitions in the "Tax Governance Code", companies will have to make a serious effort and comply with the following six main principles: (a) approach to tax – tax strategy and tax principles;[71] (b) accountability and tax governance;[72] (c) tax compliance;[73] (d) business structure;[74] (e) relationships with tax authorities and other external stakeholders;[75] and (f) tax transparency and reporting.[76] Non-listed companies are also encouraged to endorse the "Tax Governance Code".

Based on the foregoing, it is reasonable to conclude that there is a growing expectation of investors to see taxes being included in the ESG metrics, which means that companies need to improve their tax transparency and related disclosure status. A recent example of this growing interest in the 'tax conduct' of companies was the call by certain Amazon shareholders to cast a vote on the Amazon tax transparency resolution.[77] Although the Amazon tax transparency resolution did not attract majority support, the fact that more than 20% of the shareholders voted in favour remains remarkable and clearly shows how prominent tax matters are becoming.[78]

In summary, all these developments suggest that companies, particularly MNEs, will soon have to either voluntarily take action to enhance their tax transparency or be subject to mandatory requirements to do so.

5. MDBs – The Way Ahead to Include "Tax" as Part of their ESG Agenda and Goals

Based on discussions in the previous Sections, it is reasonable to conclude that responsible investors are expected to look at taxes and tax metrics as part of their ESG commitments. Yet, the content and scope of what is expected to be done in this area is far from being harmonized. It is however acknowledged that some common principles and approaches have emerged from the multiple initiatives discussed. Such common grounds would be the right basis and springboard for MDBs to consider good tax governance as part of their ESG goals and metrics.

As a starting point, it is important to note that so far the main focus of MDBs has been on considering tax as a risk that needs to be covered as part of the overall ex ante due diligence. As we have seen from the previous discussions, the current trend is for responsible investors, like MDBs, to actively contribute to the agenda of tax transparency, sustainability, and responsible taxation. The reason being that sustainable investors are also expected to take sufficient account of sustainability-related risks in their investment decisions. By doing so, it is expected that investors' "soft" pressure would trigger a change in the behaviour of companies thereby reducing aggressive tax planning and tax avoidance.[80]

The ideal MDBs tax governance framework could potentially include the following elements:

a. *Ex-ante tax due diligence:* Given the importance of tax governance, tax risk indicators should continue to be included as part of the on-boarding due diligence of new investments or when considering engaging with other co-investors or fund managers. The goal of this exercise would be to assess any potentially aggressive tax planning in the proposed investment, and to understand how such potential co-investor or fund manager approaches tax transparency reporting.

b. *Endorse a tax charter (or a good tax governance, tax code of conduct or similar tax document)*: Adopting such a binding instrument would be the key building block of the tax governance framework as it would regulate the way MDBs consider and promote responsible tax behaviour and prevent aggressive tax planning in their investments. The instrument would also serve as the basis for MDBs to promote and support good practices on tax transparency and tax reporting by their investee companies, partners, co-investors or fund managers. In this respect, see for example Norway's sovereign wealth fund "Expectation document on tax and transparency" discussed above in Section 4.

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[71] The company should see tax not as a cost factor only, but as a means for social economic cohesion, sustainable growth and long-term prosperity.

[72] Tax is a core part of corporate social responsibility and governance, and is overseen by the company's Board, including a tax control framework.

[73] The company is committed to comply with the letter, the intent and the spirit of the local tax legislation and to pay the right amount of tax at the right time.

[74] The company will only use business structures that are driven by commercial considerations, are aligned with business activity and have genuine substance and does not use so-called tax havens for tax avoidance.

[75] Mutual respect, transparency and trust drive the company's relationships with tax authorities and other relevant external stakeholders.

[76] The company regularly provides information to its stakeholders about its approach to tax and taxes paid, such as information on corporate income tax, total tax borne and collected and information on material tax incentives.

[77] By way of background, a group of shareholders called for a resolution to be discussed at this year's annual meeting for Amazon's board to issue a tax transparency report in accordance with GRI 207 - Tax. After being disputed by Amazon, the investors won their battle and this resolution was included on the agenda for the next shareholders meeting on 25 May 2022. See, for more details, https://www.ft.com/content/99481159-0f9a-416b-96cd-0012d0f2428e and https://www.reuters.com/technology/amazon-shareholders-call-tax-transparency-ft-2022-03-06/ (both accessed 21 May 2022).

[78] See https://www.innovationaus.com/more-than-20-of-amazon-shareholders-vote-for-greater-tax-transparency/ (assessed 5 June 2022).

[79] For a review of the Policy on Domiciliation of EBRD Clients and related domiciliation due diligence as well as what other MDBs are already doing in this space, see Martinho Fernandes, "Tax Good Governance – The Revised EBRD's Domiciliation Policy in Response to Recent International Tax Developments", *ALIFDO Legal Magazine* (2020), available at https://www.alifdo.com/gz2020ataxgov.html (accessed 5 June 2022).

[80] See Sonnerfeldt, supra note 4, at pp. 442-444; and Valsecchi, supra note 5, at p. 122-124, and 136; together with the references mentioned by both authors.

Admittedly, implementing such an instrument would be challenging for MDBs. The foregoing considerations may be taken into account in designing a strategy and roadmap for good tax governance:[81]

- First, MDBs should engage and call for the integration of tax metrics as part of the expected or required ESG reporting from their borrowers, partner financial institutions, investee companies or fund managers. The underlying rationale being that for ESG purposes, taxes only need to be included if a business (or organization) has identified tax matters as a material topic, and right now businesses tend not to identify tax matters as a material topic; and hence no ESG reporting is being done on this topic. This does not mean that they necessarily have to adopt a 'one-size fits all' approach[82] or prefer one particular tax standard out of the different ones currently available and which have been discussed in the previous Sections. In this respect, endorsing a tax policy, setting up a tax control framework, and requesting annual disclosures on taxes paid in the different jurisdictions where the company operates, emerge as the common elements that the different tax standards currently include and which could therefore be used as the benchmark.
- Second, MDBs should engage with MNEs only to the extent that such MNEs have endorsed responsible tax principles, tax transparency and related tax reporting, such as the GRI 207: Tax 2019, WEF's total tax contribution report or similar tax standards. In the event that an MNE has not yet endorsed such tax standards, then the MDB should engage in a governance dialogue with the MNE and make any new investment conditional upon the MNE embracing one of the tax standards within a given timeline.
- Third, MDBs should introduce new reporting obligations on tax matters, which would potentially apply annually to borrowers, partner financial institutions, investee companies or fund managers. If introduced, the new reporting obligations should be part of the wider ESG reporting obligations of such entities towards the MDBs. Essentially, due to their importance, tax transparency and tax reporting matters should not be treated in isolation but should form part of a holistic ESG analysis of the relevant investments or counterparties.
- Fourth, MDBs should actively engage in tax transparency and tax reporting discussions on their existing equity investment portfolios. Similar to the recent effort of the Amazon shareholders earlier discussed, MDBs should be seen as taking a proactive stance to ensure that tax transparency and tax reporting are included as part of the ESG/sustainability reporting of the companies they invest in.
- Fifth, MDBs should enhance their financial documentation, including shareholder agreements, to allow them to dispose of an investment if the agreed tax behaviour and tax metrics are not met by the relevant borrower, partner financial institutions, investee companies or fund managers. For example, if an investee company does not endorse tax transparency standards or engages in aggressive tax planning, and such behaviour could not be justified or adequately mitigated under the 'comply or explain' principle, then the MDB could dispose of the relevant investment.
- Sixth, MDBs should take advantage of bodies such as PRI to engage in policy discussions with other institutional investors in order to shape the way corporate tax transparency, tax reporting and tax fairness should be construed and reported on going-forward. It is only by engaging with other investors or peers with similar interests that alignment and a level playing field can be achieved. This would in turn be beneficial to all responsible investors and help avoid any unnecessary competition or desynchronization.[83]
- Seventh, MDBs should engage in policy dialogue with international and EU bodies as part of the fair taxation and sustainability agendas. If indeed tax metrics are to be included as part of the ESG agenda and of the sustainability reporting, it would be important to agree on common and harmonized metrics so as to avoid or, at least, reduce 'ESG-washing' in relation to tax matters.
- Eighth, MDBs should support their countries of operations in enhancing legislation that increases their ability to raise tax revenue and that promote good tax governance and tax transparency, including e.g., legislation on mandatory annual tax reporting. Such support should include assisting the countries in the implementation of tax reporting and metrics as part of the ESG, sustainable finance, and responsible investment framework.
- Ninth, if needed, MDBs should financially assist borrowers, partner financial institutions, investee companies or fund managers in the development and implementation of their own good tax governance practices or code, as well as in the related roll-out of the annual reporting obligations.

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[81] In this respect, the July report from the Platform on Sustainable Finance would be an important benchmark to be taken into account by any sustainable or responsible investor wishing to cover the topic of taxation, see Platform on Sustainable Finance, supra note 42, and Section 3.4.

[82] See also Valsecchi, supra note 4, at pp. 117-135, submitting that while it is time for companies to go beyond playing by the rules and move to the implementation of a good tax governance policy and reporting framework, the latter needs to be fit-for-purpose and be built on the basis of the companies' own sustainability goals, policies, and processes.

[83] Valsecchi, supra note 5, at p. 136 points out, however, that it is also time for some legislative initiative so as to have "*criteria for enabling statutory audit and assurance of sustainability reporting, and by providing sanctions against misleading reporting*", with which the author agrees. For now, as noted above, the most relevant work is the one developed by the Platform on Sustainable Finance on its July report mentioned supra in Section 3.4., and note 42.

- Lastly, MDBs should include tax transparency metrics as part of their annual sustainability or responsible investment reports. This will exhibit their commitment to tax transparency, and convey the results achieved and actions taken on their own portfolio as a result of their tax metrics.

6. Conclusion

The international and European tax landscape is evolving. The recent years have shown that there is a lack of trust on whether businesses, particularly MNEs, are paying their 'fair share of taxes' and there is a growing concern that globalization has benefitted MNEs, instead of the society and population at large. As a result, stakeholders are now asking whether companies are paying their 'fair share of tax' and are requiring more tax transparency and related tax reporting. Essentially, there is increased stakeholder interest in the societal impact of corporate tax practices, and greater demand for transparency, which is encouraging firms to go beyond simply 'playing by the rules'.

These recent developments suggest that a contemporary society does not see "Tax" as a short-term cost factor only, but as an instrument to create socio-economic cohesion, environmental value, and long-term prosperity. This is because "Tax" undeniably has an impact on the economy, the environment, and society.

"Tax" is therefore emerging as an important element of ESG. As a result, "Tax" information is increasingly becoming part of investment risk analysis, as well as the compilation of ESG rankings. Against this backdrop, stakeholders or responsible investors focused on ESG now expect companies to conduct their tax affairs in a sustainable manner, measured in terms of good tax governance and paying a 'fair share'. ESG stakeholders view the public disclosure of a company's approach to tax, the amount of taxes paid, and where those taxes are paid as important elements of sustainable tax practices. Such tax transparency and related tax reporting is about restoring trust and building a sustainable society.

In this context, there is a growing need for MDBs to develop their own framework to assist them in considering "Tax" as part of their ESG goals and commitments towards a sustainable society, which in turn will inform their good tax governance ambitions and requirements on their investments. This article has suggested that MDBs should assess potentially aggressive tax practices within their investments, support a shift away from tax practices that are short-term and unsustainable, advocate the creation of a level playing field in tax transparency and tax reporting matters, as well as communicate expectations to companies in order to drive broader societal and economic objectives. By doing so, MDBs would be at the forefront of including taxes and assessing the 'tax impact' (just like 'climate impact' is now assessed) as part of their sustainable goals and commitments.

Admittedly, the journey has just begun and questions abound on whether to include "Tax" as part of the ESG reporting and, if so, how it should be included. The article has made recommendations on how this can be done. It has also emphasized that responsible and sustainable investors, like MDBs, should play an active role in encouraging more responsible tax behaviour and promoting sustainable investments, including in relation to tax transparency and tax reporting matters.

Taking Security over Inventory: **A Comparison between the Turkish-Law Movables Pledge and the English-Law Floating Charge**

*Markus Renfert & Begüm Naz Bayirbas**

Abstract: In January 2017 the Turkish legislator introduced the non-possessory movable pledge into Turkish law. It is now possible to use this instrument to take security over inventory. By contrast, the floating charge has been used in England for the same purpose for a very long time. This article examines the features of the new Turkish law security interest when security over inventory is considered. The Turkish instrument is compared with the floating charge under English law. The Turkish legislator did not intend to replicate the floating charge. The comparison is useful, though, as Turkish policy makers and practitioners sometimes point to the floating charge as a benchmark, or even as the better alternative.

1. Introduction

Under every national legal system debtors will want to attract debt financing by offering inventory as security for a loan. Inventory as an asset class has some peculiarities. It is a pool of tangible movables, changing over time. In order to pursue their enterprise, debtors must retain possession and control of the assets and must be able to sell the assets in the ordinary course of business.

Under English law the floating charge is the legal device of choice to establish security over inventory.

Turkish law has only in 2017 introduced the possibility for a lender to take a non-possessory pledge of inventory.

This article aims at determining whether the new Turkish law movable pledge is a suitable instrument to establish security over inventory and how it compares to the English law floating charge. Indeed, the floating charge is sometimes considered in Turkiye, as in other countries,[1] to be a model to emulate. It is not intended in this article to propose a detailed comparison of both instruments, but rather to use certain key features of a security interest over inventory to highlight the differences and similarities in approach between Turkish law and English law. In doing so, this article suggests ways in which the Turkish law may be improved and notes important considerations and unclear aspects of the law of which practitioners should be aware.

2. Non-possessory security interest

In order to meet the debtor's business needs, the security interest over inventory must leave possession and control of the secured assets in the debtor's hands. While this will be a requirement for most assets granted as security, for inventory it is also fundamental that the debtor has the right to dispose of the assets. Selling inventory for cash in the ordinary course of business will be crucial to maintain the company's activity and to repay the loan.

2.1. Turkish law

Turkiye has enacted a Law on Pledge of Moveable Properties in Commercial Transactions.[2] This statute enables the establishment of a non-possessory security interest on inventory. In the past, a non-possessory security interest

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[1] For instance Croatia has introduced the floating charge in 2005.

[2] Ticari Islemlerde Tasini Rehni Kanunu, N° 6750 dated 28 October 2016. It entered into force on 1 January 2017. Hereinafter referred to as "Movable Pledge Law".

over tangible movables could only be taken through a commercial enterprise pledge or through specific regimes applicable to specific assets, such as cars, ships or aircrafts. Inventory was not part of the limited list of assets covered by the commercial enterprise pledge nor subject to any specific regime. Before the reform there was no means of taking non-possessory security over inventory. Lenders had to take possession of the inventory, often using a third party acting as agent of the lenders and taking possession of the pledged inventory on behalf of the lenders under complex contractual arrangements.

Under the new Movable Pledge Law, the debtor's right to dispose of the secured inventory is emphasized. The Turkish law specifically states that any provision that restricts the pledgor's disposal right over the pledged asset is null and void.[3]

2.2. Floating charge

The floating charge has been recognised in English law since the nineteenth century[4] and was developed through case law. The floating charge has been designed to leave possession and control over the pledged assets to the debtor. The debtor's right to dispose of the assets is an implied term of a floating charge.[5] If the contract does not specify the limits of the debtor's rights, then the disposal right is construed broadly.[6] Although there is some debate as to the exact limits of the debtor's disposal rights,[7] disposals made in the ordinary course of business, even if unusual or extraordinary, are authorised,[8] whilst disposals made with a view to a cessation of business are prohibited.[9]

3. Establishment of pledge

When taking security, practitioners will want the establishment of the security to be easy, quick and cheap. If a registry is used, it should be easily accessible, user-friendly and informative.[10]

3.1. Turkish law

Establishment of a pledge over inventory as per the Turkish law requires signing of a pledge agreement in writing or in electronic form[11] (which has to bear a certified electronic signature) and registration of the pledge with the Registry of the Pledged Movables ("TARES").[12] The law requires a notary public to certify the signatures on the agreement if it has not been signed in electronic form.

The purpose of the notary public's involvement is to check the identities of the signatories. It is widely held among scholars that if a pledge agreement is signed in writing, it will become binding between the parties even in the absence of certification by the notary.[13] However, such certification will still be required in order to proceed with the registration of the pledge with TARES. In practice, parties will have the notary certify their signatures on the same day they request registration in TARES.

The pledge is established upon its registration in TARES[14] (Art. 4). The notary public makes this registration upon the parties' request. The registration is a requirement for the creation of the security interest. If there are more than one pledge established at the same rank, the date of registration counts.

Ostensibly, only a person who can prove an interest can consult the registry.[15] In practice, however, anyone can consult the registry online, and no evidence of an "interest to consult the registry" needs to be provided. A search on the registry can be conducted online on the TARES website or through a notary public. Anyone can obtain a username and a password for TARES from a notary public by presenting an identification card and can conduct a search on TARES by entering the tax number or the MERSIS identification number of the pledgor company. A search will list the name of the pledgee, list of pledged assets, the pledge's registration date, rank and degree, the amount of debt and the right to escalate to upper rank (if provided).[16]

3.2. Floating charge

The floating charge is established by contract, usually under a debenture agreement.

The floating charge must be registered to be enforceable against third parties. The debtor has a duty to register the charge.[17] The registration is not a validity, but a perfection requirement.

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[3] Art. 4 of the Movable Pledge Law.

[4] Holroyd v Marshall (1861-1862) 10 HLC 191; Re Marine Mansions Company (1867) LR 4 Eq 601; Re Panama, New Zealand and Australian Royal Mail Company (1869-70) LR 5 Ch. App 318; Pennington, *The Genesis of the Floating Charge* (1960), 23 Modern Law Review 63, at 630.

[5] Worthington, *Floating Charge – An Alternative Theory* (1994), CLJ Vol 53 No 1 at 86.

[6] Goode and Gullifer, *On Legal Problems of Credit and Security* (2017), at 5-42.

[7] Worthington, *Floating Charge – An Alternative Theory* (1994), CLJ Vol 53 No 1, at 86; Ferran, *Floating Charges – the Nature of the Security* (July 1998) CLJ 47(2), at 213, 229; Gulliver, Payne, Corporate Finance Law (2017), at 289.

[8] Re Vivian & Co. Ltd [1900] 2 Ch. 654.

[9] Hubbuck v. Helms (1887) 56 L.J. Ch. 536.

[10] EBRD Core Principles for a Secured Transactions Law, principles 2 and 8.

[11] Although not yet common in Turkish practice, the COVID-19 situation may increase the number of companies signing these agreements in electronic form, which will avoid the notarial identity check of signatories.

[12] The registry is called "Tasinir Rehin Sicil Sistemi", which is shortly named as "TARES".

[13] Vural. *Ticari Islemlerde Tasinir Rehni Kanunu'na Gore Tasinir (Varlik) Rehni* (2019), at 123-124.

[14] Art. 4 of the Movable Pledge Law

[15] Art. 26 and 30 of the Regulation on Movable Pledge Registry as published on Official Gazette dated 31 December 2016 and numbered 29935 ("Movable Pledge Registry Regulation").

[16] Art. 32 of the Movable Pledge Registry Regulation lists these as the information that is available in registry search.

[17] Section 860(7)(g) Companies Act 2006.

For ranking purposes, it is the date of creation of the charge and not the date of registration that counts. Third parties looking at the registry may not know whether an earlier charge has been created, but has not yet been registered within the 21 days registration period. This is a major weakness of the English system.

The Companies House's register is easily accessible on-line by anyone.

4. Future property

When taking security over changing inventory, it is crucial that future inventory can be covered. Ideally, future property is automatically subject to the security interest when it comes into existence and no additional formalities are necessary.

The Turkish law explicitly states that the parties can decide to establish the pledge on future property.[18]

However, the current market practice is tending towards updating the pledge registration and filing a description of the new assets. Indeed, the regulation dealing with the registration states that the parties shall provide information that specifies the asset that is subject to the security.[19] Traditionally, the Turkish law on security interest is strict about proper identification of secured assets. An updated registration will prevent any dispute about whether the initial description was accurate enough to cover the new assets.

This precautionary measure does create administrative burden and costs for the parties. The parties need to make an online application on TARES, submitting, among other information, a new pledge agreement and the list of new assets. Once the online application is carried out, the parties will need to present the online application number to a notary together with documents evidencing the signatories' authority.

The better view should be that a generic description in the initial pledge should be sufficient to cover future assets. This is the approach used under English law. The floating charge covers future property. No particular formalities are necessary for the charge to cover future assets. The future assets must be identifiable, but a generic description is sufficient.[20]

5. Proceeds of sale and receivables

5.1. Turkish law

The Movable Pledge Law explicitly indicates that future proceeds of the secured movable property which have arisen as a result of legal transactions, including interest and insurance proceeds, fruits or replacement assets are within the scope of the pledge, together with the movable property.[21] Accordingly the proceeds of the sale of secured assets and related receivables fall under the scope of the pledge. In practice, it is advisable to establish a separate bank account for such sale proceeds in order to reduce the risk of commingling with other cash and loss of the preferential right.

5.2. Floating charge

Under English law it is not clear whether the proceeds of the sale of pledged inventory or the receivables against the inventory buyer would automatically fall under the floating charge.[22] Since at the time of disposal, the asset is no more subject to the floating charge, arguably the asset's substitute is free from the floating charge as well, unless specifically included in the scope of the floating charge.[23] In practice, the parties must regulate this point expressly in the debenture.

6. Over-collateralisation

Under the Movable Pledge Law, in order to protect the borrower from over-collateralisation, the pledged assets cannot exceed 120% of the secured obligations.[24] The valuation of the pledged assets does not necessarily need a third party assessment. It can be agreed by the parties.[25] It must be included in the pledge agreement. There is no obligation to maintain this ceiling during the life of the loan. For a loan with a repayment schedule, the protection from the borrower's point of view will erode with time. The 120% ceiling will apply to the pledge of movable assets only; it does not prevent the creditor from requesting security on other type of assets and reaching a higher security coverage ratio on an aggregate basis.

It must be noted that according to the Turkish regulation the over-collateralisation limit applies only to secured obligations to the extent they constitute a "certain debt amount". Some market participants take the view that a loan agreement would not be qualified as a "certain debt amount". It is believed that while the principal of the loan can be known at the time the security is established, the outstanding amount could also include interest, default interest, unpaid fees, which cannot be quantified at the outset. This view would considerably reduce the application of the over-collateralisation limit.

There are no such over-collateralisation limits applicable to floating charges.

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[18] Art. 5(3) of the Movable Pledge Law.

[19] Art. 23 of the Movable Pledge Registry Regulation.

[20] Gulliver, Payne, *Corporate Finance Law* (2017), at 283.

[21] Art. 7(1) of the Movable Pledge Law.

[22] Ferran and Ho, *Principles of Corporate Finance Law* (2014), at 319.

[23] Atherton, Mokal, *Charges over Chattels – Issues in the Fixed/Floating Jurisprudence* (2004), at 4.

[24] Art. 11(2) of the Regulation on the Establishment of Pledge of Movable Properties in Commercial Transactions and Use of Rights Upon Default as published on Official Gazette dated 31 December 2016 and numbered 29935 ("*Ticari İşlemlerde Rehin Hakkinin Kurulmasi Ve Temerrüt Sonrasi Haklarin Kullanilmasi Hakkinda Yönetmelik*" in Turkish) (the "Regulation on Movable Pledge Establishment and Default").

[25] Art 7 and 9 of the Regulation on Valuation of the Movable Assets in Commercial Transactions as published on Official Gazette dated 31 December 2016 and numbered 29935 ("*Ticari İşlemlerde Taşinir Varliklarin Değer Tespiti Hakkinda Yönetmelik*" in Turkish).

7. Security interest and sale to third party purchaser

The value of a security interest for the security holder will depend on whether it can be held against a third party purchaser who acquired the secured asset. In the case of security over inventory, however, it is key that the debtor remains entitled to sell the charged assets. The debtor will only be able to repay the loan if he is able to continue to run his enterprise and sell the inventory for cash. The debtors' customers, who purchase the goods, will expect such goods to be unencumbered.

7.1. Turkish law

The Turkish law specifically states that any provision that restricts the pledgor's disposal right over the pledged asset is null and void.[26] However, as long as the pledge is registered, the purchaser would take the asset with the pledge, unless he is a bona fide purchaser.[27] And in order for the pledge to be de-registered, the debtor will need the pledgee's consent.

7.1.1. De-registration

The release and de-registration of assets to be sold require an application by the pledgee to a notary public. The existing movable pledge, pledge certificate, evidence of signatories' authorities and the list of assets to be released must be submitted to the notary public.

If the release of assets is coupled with a registration of new assets, as is usual for inventory, the formalities for the new assets must be added to the release formalities. Indeed, the current registry does not allow to simply provide a new list of assets, combining in one document the released assets and the new pledged assets.

7.1.2. Time gap between sale and de-registration

The debtor, for instance a commodity trader with fast turning inventory, will want a quick release of the security interest when selling the inventory. It is crucial for such trader to be able to sell an unencumbered commodity to his customers.

However, in practice it is not always possible to deregister the pledge from the TARES registry at the time of the sale. The financier will not be able to commit resources to react instantly to a release request, in particular if the release requires carrying out certain formalities and making a visit to a notary public. This is particularly true for the commodity trader, who may sell commodities on a daily basis. The parties will often agree to effect the de-registration on a periodical basis, for instance every quarter or every month.

In the case of a pledge of fast turning inventory, there will be a time gap between the time the pledgor sells the commodity to its customers and the time the pledge is de-registered from TARES. Third party buyers could take comfort from the automatic release provisions in the pledge agreement and consider the TARES deregistration to be a mere formality. But, if the release conditions specified in the pledge agreement make the release subject to the absence of any default or make it subject to a minimum amount of inventory still being pledged, then it becomes difficult for the third party buyer to take comfort. Indeed, he will not be in a position to verify whether those conditions are met. Nor will it be possible in practice to obtain a certificate from the financier that these conditions are met. In those circumstances, until the de-registration, the third party buyer will take the risk that he bought the inventory subject to a pledge.

7.1.3. Bona fide acquisition

Article 7/3 of the Movable Pledge Law provides that the property right of the bona fide third person, who purchased the pledged assets without knowing or having to know that the purchased asset was pledged to another party, is protected.

This rule weakens the pledgee's right and the reliance he can put on the registration of his pledge. But for inventory it meets the legitimate interest of the buyer. The inventory consists of the very products the pledgor puts on the market for sale. A buyer should be entitled to assume that he can buy these products free of any encumbrance. A different view could be taken for equipment, necessary for the production of goods to be sold, but not meant itself to be sold.[28] It is even argued that the bona fide rule should not apply to inventory, if the inventory sold is of a quantity or value which would be inconsistent with the pledgor's ordinary business transactions.[29] But Turkish law does not make any of these distinctions and the bona fide rule applies to any type of inventory and equipment.

Under the bona fide rule a purchaser has no duty to check the registry. However, since many companies use bank finance to fund their working capital and such bank finance would often be secured with inventory, it is questionable whether buyers can ignore this market practice and rely on the bona fide rule.

7.2. Floating charge

The English law floating charge provides a better solution. In the ordinary course of business prior to any crystallisation, the chargor under a floating charge can continue to deal with the secured assets and can transfer them to third parties unencumbered by the security interest.[30]

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26 Art. 4 of the Movable Pledge Law.

27 See below 8.1.3 Bona fide acquisition

28 Seven, *Ticari Islemlerde Tasinir Rehni Kanunu'na Gore Tasinir (Varlik) Rehni* (2019), at 36-37

29 V Seven, *Ticari Islemlerde Tasinir Rehni Kanunu'na Gore Tasinir (Varlik) Rehni* (2019), at 36-37.

30 Re Spectrum Plus Ltd [2005] 2 AC 680, HL, [111] per Lord Scott.

8. Security interest and third party purchaser in case of selling restrictions

In practice, lenders will generally set some limits to the borrower's disposal right.[31] They may make disposal subject to there being no payment default or default of other obligations under the loan agreement. They may also require that there should be a minimum amount of inventory pledged at all times.

8.1. Turkish law

As mentioned above, under Turkish law, provisions that restrict the debtor's right to dispose of the pledged asset are null and void.[32] This provision is consistent with the law's objective to allow the debtor to continue to sell inventory in the ordinary course of business. Since sale proceeds and sale receivables are automatically covered by the pledge, the lender continues to benefit from some protection when pledged assets are sold.[33] The current regime does not require the pledgee's consent to any disposals, including the transfer or even the consumption of the pledged asset.[34]

It has been argued that the pledgor's freedom of disposal shall be limited to disposals made by the pledgor in good faith.[35] Disposals outside the ordinary course of business or made to deliberately harm creditors should not fall within the freedom of disposals. It remains to be seen if Turkish courts will follow this suggested approach.

Similarly to the bona fide acquisition rule discussed above, it has been held that, while the freedom of asset disposal is appropriate for inventory, it may not be adequate for equipment and other movable assets not meant to be sold.[36] This view raises the broader question whether a security interest for inventory needs to be treated differently than a security interest for other types of movable assets.

A broad freedom of disposal goes against the lenders' interest, though. Indeed, in certain circumstances, the lender has a legitimate interest to restrict disposals of secured assets. First, the lender will not want the whole inventory to be sold at once with no replacement, in effect discontinuing the debtor's business and jeopardizing the repayment of the loan. Second, if the debtor is in covenant breach or worse in payment default, the lender will want to take back control over the secured assets.

It could be argued that the lender is sufficiently protected since his pledge is maintained even if the assets have changed hands (unless acquired bona fide). In case of payment default or covenant breach, the lender will also usually have the right to trigger an anticipated repayment of the loan, which in turn would entitle the lender to enforce his security interest.

However, in practice it will be difficult to enforce a pledge when the pledged assets are circulating outside of the debtor's control, possibly being transformed and integrated in other products, or having been acquired by a bona fide purchaser.

In the absence of any other breach, it would not be possible to use the anticipated repayment trigger to protect a covenant to hold a minimum level of pledged inventory at all times.

It also seems odd that an unsecured lender could trigger an early repayment in case of breach of disposal restriction, while a secured lender could not. The prohibition would also prevent any covenant requiring the pledgor to hold a minimum amount of pledged inventory at all times.

At a time when the debtor steps outside of the ordinary course of business, either because he sells all or too much of his inventory or because he is in financial difficulties, the lenders must be in a position to take back control of the pledged asset on the basis of pre-defined disposal restrictions.

In the light of legitimate interests of the lenders, the broad statutory prohibition of disposal restrictions in Turkish law goes too far.

8.2. Floating charge

Under the floating charge agreement, parties can agree on selling restrictions.[37] If the selling restrictions are so severe as to take away the debtor's control over the assets, then the floating charge would be requalified as a fixed charge.

The position of the purchaser acquiring an asset subject to a floating charge is relatively complex.[38] It will depend on whether the acquisition was done in the debtor's ordinary course of business, whether crystallisation had occurred and whether he had notice of the selling restriction and crystallisation.

If the chargor sells to a purchaser in violation of a selling restriction, the purchaser will take the asset unencumbered provided that the transaction falls within the chargor's ordinary course of business, even if the purchaser was aware of the existence of a floating charge.

If the purchaser has notice of the selling restriction or if the transaction was outside the debtor's ordinary course of business, the purchaser would take the asset subject to the floating charge and would lose priority upon crystallisation.

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[31] Calnan, *Taking Security* (2018) at 164, n° 5.50.

[32] Under the legal regime prior to the reform the pledgor had to obtain the consent of the pledgee to dispose of the pledged assets.

[33] Art. 7(1) of the Movable Pledge Law.

[34] Antalya, Acar, *Ticari Islemlerde Tasinir Rehni* (2017), at 135; Esener, Guven, *Esya Hukuku* (2017), at 585.

[35] Antalya, Acar, *Ticari Islemlerde Tasinir Rehni* (2017), at 136.

[36] Seven, *Ticari Islemlerde Tasinir Rehni Kanunu'na Gore Tasinir (Varlik) Rehni* (2019), at 21.

[37] Atherton, Mokal – *Charges over Chattels – Issues in the Fixed/Floating Jurisprudence* (2004), at 1.

[38] Goode and Gullifer, *On Legal Problems of Credit and Security* (2017), at 5-40.

The events triggering the selling restrictions (for instance payment default, financial covenant breach or security coverage breach) would usually also trigger the crystallisation of the floating charge. The charge would become a fixed charge. With a fixed charge, the creditor regains control over the charged assets and the debtor cannot sell the charged assets without the creditor's consent. The debtor can be restrained from disposals by injunction.

However, there is no system for registration of crystallisation. The question whether crystallisation can be held against a third party buyer of the pledged asset has not been settled under English law. The predominant view seems to be that the crystallised floating charge cannot be held against a purchaser, who has no actual knowledge of the crystallisation,[39] certainly when the transaction is in the debtor's ordinary course of business.[40]

8.3. Ranking *vis-à-vis* creditor with security on same assets

The value of a security interest for the security holder will depend on whether it can be held against a creditor with a later security interest on the same assets.

Under Turkish law, as long as the inventory pledge is registered, any subsequent security on the same asset will be subject to the inventory pledge which was registered first and has first ranking.

The floating charge allows the debtor to continue to deal with the charged assets, including by granting a subsequent security interest. A subsequent fixed charge holder acquires his right free of the floating charge.[41] The lack of priority of the floating charge is a significant weakness of this security interest. It explains why in practice the floating charge is often taken together with fixed charges.[42]

In order to avoid later fixed charges, which would take priority ranking, the holder of a floating charge can include a negative pledge clause in the legal documentation. The negative pledge clause is mentioned in the registration form and will be reflected in the registry of the Companies House. If registered, the negative pledge clause will prevent any subsequent chargee from acquiring security unencumbered.

Interestingly, under English law, a subsequent lender financing and taking a charge on inventory would take priority over the floating charge, even if he had knowledge of a negative pledge clause. The main argument for this rule is that it would be unfair for the first lender to take benefit of the inventory financed by another lender.[43] This rule, reflecting an obvious business rationale, could be easily introduced in Turkish law. Alternatively, the issue of ranking could be tackled via an over-collateralisation limit freeing up inventory that could be granted as security for a future lender.

9. Enforcement

9.1. Turkish law

Upon a payment default, the first-degree holder of a movable pledge may request from the execution office[44] the transfer of the ownership of the pledged movable assets to himself.[45]

The creditor will also still have creditor rights under the general provisions of the Execution and Bankruptcy Law.[46] Accordingly, a pledgee can seek enforcement through public auction upon application to the relevant execution office. In practice, enforcement proceedings usually take a period of approximately six months to a year provided that no objections are raised by the security provider. In the event that an objection is raised and a lawsuit is filed before a Turkish court, the enforcement proceedings may take two to three years. The length of enforcement proceedings is a general weakness of security interests under Turkish law.

The regulations provide the pledgee with options for further enforcement; for instance, the creditor is entitled to transfer the asset to third parties. In that case, that third party will be subrogated to the creditor's claim against the borrower.[47]

Another option expressly mentioned by the Movable Pledge Law[48] is the sale of the creditor's secured receivable to an asset management company licensed in Turkiye that is specialised in restructuring and enforcing unpaid debts.

9.2. Floating charge

The holder of a floating charge has a statutory right to sell the secured asset either by private contract or public auction[49] without the need to involve a court.

The holder of a floating charge has a statutory right to appoint an ordinary receiver, who can manage the charged asset.[50] In the past, the chargee could appoint an administrative receiver, who could deal not only with the charged assets, but with the whole of the borrower's assets. This right has been restricted. However, it can still be used

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[39] Ferran and Ho, *Principles of Corporate Finance Law* (2014), at 337.

[40] Goode and Gullifer, *On Legal Problems of Credit and Security* (2017), at 5-53.

[41] Ferran and Ho, *Principles of Corporate Finance Law* (2014), at 339.

[42] Mokal, *The Floating Charge – An Elegy, in Worthington (ed), Commercial Law and Commercial Practice* (2003), ch. 17, at 6.

[43] Gulliver, Payne, *Corporate Finance Law (*2017), at 322.

[44] Execution offices (*"icra daireleri"* in Turkish) are authorized to carry out execution proceedings in Turkey, including implementing attachment, sale, and collection procedures. Upon receipt of a court order, the execution office would request the relevant movable property to be delivered to the debtor within seven days by sending an execution order.

[45] Article 14/1 of the Movable Pledge Law.

[46] Icra ve Iflas Kanunu, N° 2004 dated 9 June 1932. Hereinafter referred to as "Execution and Bankruptcy Law".

[47] Article 41 of the Regulation on Movable Pledge Establishment and Default.

[48] Article 14/1 (b) Movable Pledge Law.

[49] Section 101(1)(i) Law of Property Act 1925.

[50] Section 101(1)(iii) Law of Property Act 1925.

in certain important cases, for instance for public-private partnerships or project financings.[51]

The holder of a so-called qualifying floating charge over all or substantially all of the debtor's assets can appoint an administrator using an out-of-court process.[52] The administration will be a collective insolvency procedure for the benefit of all creditors,[53] unlike the administrative receivership where the administrative receiver's principal duties are to the secured creditor that appointed him.

Beyond the statutory enforcement rights, English law allows the parties to agree further enforcement rights. A contract (debenture) between the creditor and the debtor would generally confer a power of sale to the creditor, which would ease certain of the conditions applicable to the statutory right of sale, for instance with respect to notice periods.

The parties can also provide for the floating charge holder to be entitled to take possession or they can extend the ordinary receiver's powers, for instance by including a right to sell the charged assets.

10. Ranking in insolvency

10.1. Turkish law

Under Turkish law,[54] the receivables of secured creditors have priority access to the sale proceeds of the secured assets after deduction of the relevant taxes (e.g. taxes arising from the use or mere existence of the secured assets such as real estate taxes, motor vehicle taxes, custom duties, etc.) and expenses arising from the administration or preservation of the secured assets or from sale auctions. The remaining assets will then be distributed to preferred creditors such as employees and other creditors with preferred status under specific laws. Other unsecured creditors will come last. Therefore, the holder of an inventory pledge in an insolvency scenario in Turkiye (whether the pledgor was in default or not) will have priority over all other creditors with respect to the sale proceeds of the secured asset. He will rank *pari passu* with unsecured creditors for the portion of his claim not covered from the sale proceeds of the secured assets.

10.2. Floating charge

In an insolvency scenario, the floating charge, whether crystallised or not, will be less protective than the fixed charge. Preferential creditors[55] and expenses for the winding up[56] will rank ahead of the floating charge holder. A prescribed part of the net realisation proceeds of assets of the company covered by the floating charge will be set aside for unsecured creditors.[57] Furthermore, the administrator will be entitled to use floating charge assets without the consent of the chargee or the court.[58] The administrator can raise new financing ranking ahead of the floating charge.[59]

A floating charge is also more vulnerable than a fixed charge to avoidance rules.[60] Case law, which has for long considered that the granting of security cannot constitute a transaction at undervalue[61] (because the security interest does not deplete the asset), is not applicable to floating charges. The floating charge is subject to a specific statutory regime with respect to the avoidance of transactions at undervalue.

10.3. Release

Under English law, the timing of the final release of the floating charge is left to the parties to negotiate. Usually, the security document provides that the lender shall carry out whatever is necessary to release the pledge once the secured obligations are fully discharged.

Under Turkish law, the legislature has set some strict deadlines for the release. The pledgee should apply to the registry for release, within 15 days (30 days if residing abroad) starting from the day the debt is discharged.[62] In case of breach of this provision, the fines are substantial: 10% of the total secured debt amount.

11. Conclusion

Both the floating charge and the Turkish law movable pledge allow the establishment of security over changing inventory. Both enable the debtor to remain in possession and control of the inventory and to dispose of such inventory.

The establishment of the security interest carries less formalities under English law. While the English registry is more user-friendly, it has the disadvantage of setting the ranking according to the date of creation of the floating charge (to the extent later registered in time), not the date of registration. The involvement of a notary for the establishment and update of the pledge in Turkiye generates additional formalities. In times of severe business disruptions, for instance due to the Covid-19 pandemic, the

[51] Insolvency Act 1986, section 72A to 72GA.

[52] Insolvency Act 1986, Sch B1 para 14.

[53] Ferran and Ho, *Principles of Corporate Finance Law* (2014), at 302.

[54] Art. 206 of the Execution and Bankruptcy Law.

[55] Insolvency Act 1986, section 175.

[56] Insolvency Act 1986, section 176ZA.

[57] Insolvency Act 1986, section 176A.

[58] Insolvency Act 1986, Sch. B1 para 70.

[59] Insolvency Act 1986, Sch. B1 para 99(4).

[60] Insolvency Act 1986, section 245.

[61] Re MC Bacon Ltd [1990] BCC 78; however, see Hill v Spread Trustee Company and another [2006] EWCA Civ 542, which seems to open up the point.

[62] Art 15 Movable Pledge Law.

requirement to involve a notary in the establishment of the pledge creates practical issues.

Both system allow the security interest to cover future assets. In the absence of a clear recognition that a generic description of assets is sufficient, the current practice in Turkiye to de-register released assets and register new assets is too burdensome. The Turkish registry system would benefit from a more user-friendly approach. To limit the time gap between sale and de-registration, the system must be easily accessible by pledgees. Pledgees should be put in a position to release assets and modify registered asset lists easily, without the need for new pledge agreement or notary involvement.

Sale proceeds and receivables are included by law in the Turkish law movable pledge, not so in the floating charge.

The debtor's interest to be protected against creditors' attempts to obtain over-collateralisation is taken into account in Turkish law. However, the provision is not very effective, since the over-collateralisation limit only applies at the outset and is understood to apply to "certain debts" only, which would exclude typical lending arrangements.

The prohibition of any selling restriction in the Turkish movable pledge does not meet legitimate interests of the lender when the debtor's financial condition deteriorates. The better approach is to let the parties agree under what conditions the lender can take back some control over the pledged assets. In fact, English law rules on the crystallisation of the floating charge can be taken as an example of a mechanism where the disposal right of the pledgor is restricted when certain trigger events occur.

The priority rules applicable when a floating charge holder competes with third party interests are complex. The priority will depend on the type of creditor, whether crystallisation has occurred and whether the creditor had notice of a floating charge, of disposal restrictions or crystallisation. By contrast, the Turkish system is simple: any subsequent creditor's security interest will be subject to the movable pledge as long as it is registered. The same will be true for purchasers, unless they are bona fide.

The English law rule that a subsequent lender, financing inventory and taking security over such inventory, takes priority over an earlier floating charge appears appropriate and could be incorporated in Turkish law as well. This would prevent a first lender to over-collateralise his loan. Under English law, a debtor's customer need not be concerned with the existence of a floating charge. Such customer will acquire unencumbered, unless the acquisition is outside of the debtor's ordinary course of business, or it has notice of a selling restriction or the charge is crystallised and it has notice of it. Under Turkish law, a debtor's customer acquiring inventory will feel safe if the pledge has been de-registered, but he may also benefit from the bona fide rule.

The statutory provisions coupled with the wide contractual freedom in respect of the means for enforcement under English law certainly meet the parties' interests. Under Turkish law, enforcement means are more limited, but the main drawback is the length of enforcement proceedings.

In an insolvency, the floating charge is less robust than a fixed charge. The floating charge holder's rights are subject to certain carve-outs in favour of unsecured creditors. In Turkiye, the pledge over inventory is treated in insolvency like any other security interest. The pledgor has a priority right on the asset over any other creditor. In this sense, the holder of an inventory pledge under Turkish law has a robust position.

As the comparison shows, it is not obvious to determine which of the Turkish security interest or the floating charge is the better alternative when inventory is to be secured. Both instruments have advantages and drawbacks. The comparison gives useful insights about the areas that can be improved, though, and in some instances there are mutual lessons to learn.

Overall, the introduction of the floating charge into the Turkish legal system does not seem the way forward. The floating charge is the result of more than a century of case law and a set of scattered statutory provisions, which cannot be easily incorporated into another normative system.[63] And perhaps English law may one day replace the floating charge with another type of security interest.[64]

Turkish law has made a significant step forward in introducing a non-possessory security interest that can be used to take security over inventory. Since the instrument has been introduced only recently, it will be up to practitioners and courts to develop the law and fix some of the issues highlighted above.

A broader question is whether the specific nature of inventory calls for a specific security interest with a legal regime different from the regime applicable to other movable assets. In several instances (bona fide acquisition; freedom of disposals) it appeared that under Turkish law it may, indeed, be worth considering using different rules for inventory and other movable assets.

[63] See Secured Transactions Law – The Case for Reform, at 4, https://securedtransactionslawreformproject.org/the-case-for-reform/.

[64] The April 2016 Draft Policy Paper of the Secured Transactions Law Reform Projects advocates the abolishment of the floating charge – https://stlrp.files.wordpress.com/2016/05/str-general-policy-paper-april-2016.pdf.

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