



EUROPEAN CENTER FOR NOT-FOR-PROFIT LAW

Comments on Draft Recommendations to Member States Regarding a Code of Conduct for Non-Profit Organisations To Promote Transparency and Accountability Best Practices

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Regarding a Code of Conduct for Non-Profit Organisations
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Executive Summary

The European Center for Not-for-Profit Law (ECNL) commends the European Commission for its efforts to provide guidance to its Member States on the implementation of the FATF Special Recommendation VIII on Non-Profit Organisations. We are grateful for the opportunity to provide comments, which are summarized here below.

Overall Comments:

- The purpose and scope of the Draft Recommendations should be clear as to whether the intent is to address counter-terrorism concerns through oversight mechanisms (at the national or supra-national level) or to more broadly promote the transparency and accountability of NPOs through a code of conduct.
- If the intent is to support a voluntary code of conduct, then the code should be the end result, and not the beginning, of a long process of education and consultation within the NPO sector.
- If the intent is to support a certification program based on the code, then the program must be carefully considered to ensure it meets the local and European-wide circumstances.
- The Draft Recommendations are silent on scalability, recommending the application of the same standards and requirements to all NPOs, regardless of their size, purpose and experience.

Specific Issues:

- The title of the Draft Recommendations is limiting and should be revised to reflect the apparently broader purpose of the document.
- The definition of “NPO” is confusing and should be clarified as to the intended group targeted by the Draft Recommendations.
- Section A.1 should be reviewed carefully to ensure that the oversight mechanisms do not conflict with existing national-level legal requirements or international law.
- Section B should be reviewed carefully to ensure that the code provisions do not merely repeat already-existing legal requirements, that all terms are clear, and that they address fundamental issues of accountability.
- The Annex should be reviewed carefully to ensure a connection between the risk indicators and potential terrorist financing and other forms of abuse.



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The European Center for Not-for-Profit Law (ECNL) is an international organization working in Europe to promote an enabling legal environment for civil society. ECNL provides assistance on the development of laws and regulations supporting civil society organizations and public participation; empowers local partners throughout Europe to undertake core law reform activities affecting civil society; offers database and web resources, consulting, and other services; conducts comparative research on legal issues; and shares comparative expertise across borders. With support from the European Commission, the UN Development Programme, Transparency International, the U.S. Agency for International Development, and organizations throughout the region, ECNL engages on a range of issues relating to the laws supporting civil society, from freedom of association to registration, from financial sustainability to EU enlargement, from good governance to public participation. In cooperation with the CEE Working Group on NGO Governance and the Trust for Civil Society in CEE, ECNL recently published *A Handbook of NGO Governance*, a groundbreaking publication to address the challenges in good governance facing NGOs in this region (www.ecnl.org/dindocuments/18_Governance%20Handbook.pdf).

ECNL is grateful for the opportunity to comment on the *Draft Recommendations*.¹ We are concerned, however, that a 30-day comment period during August provides insufficient opportunity for the many concerned stakeholders to provide feedback on the *Draft Recommendations*.² Where codes of conduct are concerned, the process of defining standards should be as inclusive and participatory as possible. We therefore hope that there will be more opportunities for NPOs and other stakeholders to be involved in the development of this document.

Overall Comments

The European Commission is to be commended for its efforts to provide guidance to its Member States on the implementation of the FATF Special Recommendation VIII on Non-Profit Organizations. The *Draft Recommendations* represent a well-timed effort to balance the challenges of regulating NPOs consistent with SR VIII against the need to avoid over-burdening the sector and to foster its growth and development. We support the EC's recognition of the need for care "to ensure that nothing is done to undermine the work or reputation of the vast majority of legitimate non-profit organizations operating at national, EU, and international levels."

¹ The full title of the document is *Draft Recommendations to Member States Regarding a Code of Conduct for Non-profit Organisations to Promote Transparency and Accountability Best Practices*. We will hereinafter refer to the document as simply *Draft Recommendations*.

² The European Commission's DG "Justice, Freedom and Security" opened the consultation period on the *Draft Recommendations* on July 26 for 30 days.

Purpose of Draft Recommendations. As written, the *Draft Recommendations* raise a number of questions relating to their purpose, reach and impact. On the one hand, the *Draft* is focused on examining the state's oversight mechanisms in light of counter-terrorism and money laundering. On the other hand, the *Draft* proposes a Code of Conduct, which clearly would have a broader reach and impact on the non-profit sectors in Europe.

If the prevention of terrorist financing and other criminal abuse is the actual objective of the *Draft Recommendations*, then measures specifically and more precisely targeting such activities could be developed. These may relate to the strengthening of the regulatory framework in those countries where it seems inadequate to address the identified risks, or the introduction of specific criteria for NPOs to be eligible for EU funding. The *Draft* must be careful, however, to avoid recommending requirements overlapping with existing regulation, which would lead to data duplication. NPOs should not be asked to comply with administrative requirements in the form of providing data that is already at the disposal of some state authority (whether registry office, tax authorities, or others). Moreover, it is not clear if the *Draft* is directing Member States to consider national-level regulation or is referring to an additional European-level regulatory mechanism. An additional supra-national registration (or certification) mechanism would certainly create additional burdens but not necessarily lead to greater accountability and transparency.

If, however, the aim is a broader regulation of the nonprofit sector and the facilitation of a Code of Conduct, then the *Recommendations* deserve more time, thought and consultation, as highlighted below.

The Importance of Process. The FATF SR VIII Best Practices Paper³ recognizes that NPO self-regulation can be an important means of enhancing NPO accountability and transparency, and strengthening NPOs against misuse for purposes of money laundering or terrorist financing. Nevertheless, with respect to a voluntary code of conduct, it is important to consider the appropriate role of the EC and the Member States in encouraging what is, in the end, a civil society initiative. The *Draft Recommendations* go so far as to propose, in Section B, specific terms for a code of conduct. A code of conduct, however, is usually the end result, not the beginning, of a long process of education and consultation within the NPO sector. The ability to craft and gain adherence to such terms presupposes among other things:

- The existence of appropriate intermediary support organizations or others with sufficient credibility within the sector to draft and organize adherence to a code;
- Appropriate incentives for NPOs to join and support a code; and
- Widespread capacity within the sector to adhere to rigorous governance standards and the existence of educational programs designed to raise this capacity.

The recommendation of particular standards is therefore perhaps premature as long as these preliminary issues have not yet been addressed.

Certification Program. The *Draft Recommendations* suggest exploration of a certification program based on the code, with possible restriction of certain member state or EU benefits to NPOs receiving certification. Elsewhere, the *Draft* suggests development of a "European Label" or similar device to identify those NPOs who are in compliance with a code (and perhaps more worthy of government funding). A key question, however, of who might provide such certification, remains unaddressed.

³ Financial Action Task Force on Money Laundering, Combating the Abuse of Non-Profit Organisations, International Best Practices, 11 October 2002.

There are several examples in which government authorities recognize the determinations or recommendations of a not-for-profit certification organization in deciding whether to convey certain benefits. These include the Philippine Council on NGO Certification and the Pakistan Centre for Philanthropy, as well as the Dutch Central Bureau on Fundraising (all of which have government grants of authority to certify those organizations entitled to receive certain benefits). Commentators have cautioned, however, that these models were developed under very particular circumstances and cannot necessarily be exported easily to other jurisdictions. Any certification or labelling model will need to be considered carefully to determine that it appropriately considers local and regional (European-wide) circumstances.

Moreover, studies of well-reputed certification programs⁴ have suggested that a number of factors need to be considered in whether a particular program can have common application in determining eligibility for government or other benefits. These include:

- The goal involved in the certification program, and the audience it is intended to serve;
- Whether participation in a program should be mandatory – i.e., a requirement for certain types of funding -- or voluntary;
- The degree to which existing programs can be replicated and scaled up to meet increased demand for certification;
- The capacity of applicants and their ability to access the program;
- Whether certification issued by one or more programs will be honoured;
- Who should serve as the convener of any discussion regarding a common certification mechanism.

One size does not fit all. The *Draft Recommendations* and proposed Code of Conduct fail to recognize that the NPO sector is made up of a diverse range of organisations of varying size, purpose and experience. Instead, they appear to contemplate that all organisations will comply with the same set of standards. Costs of compliance for small organisations, however, may be too high. Nearly all national-level regulation recognizes this by requiring through graduated levels of transparency and accountability. Large public benefit organisations (as measured through annual income, for example) may be required to file annual reports with the regulatory authority, disclose those reports to the public, and conduct independent audits. Public benefit organisations falling below the legal threshold may simply be required to retain accurate records, in case of inspection. Accountability requirements should also be scaled according to the potential risks posed by an organisation. Indeed, The FATF Best Practice Paper on Combating the Abuse of Non-Profit Organizations recognizes the need for flexibility and proportionality, and that small or local organizations receiving little public funding may not require substantial government oversight.

Suggested Actions. It is important that the EC support NPO initiatives in the area of self-regulation, so that NPOs can develop their own standards for improving accountability and transparency. Any such initiative, in order to be effective, must be widely participatory, engaging representatives from many types of organizations from across the sector.

To assist Member States in promoting NPO self-regulatory efforts, we recommend that an important first step would be to map existing certification and self-regulatory initiatives. Support could go further, however, to include further research, aid to ISOs, provision of forums in which participatory discussions of such models could be held, among others. There are many models both for standards

⁴ See, e.g., NGO Accreditation and Certification: The Way Forward? An Evaluation of the Development Community's Experience, prepared by the International Center for Not-for-Profit Law (ICNL), 2004.

for codes of conduct, and for how to organize self-regulation programs. ECNL would be happy at an appropriate time to supply information on these models.

Specific Issues

Title

We suggest that the title of the *Draft Recommendations* is somewhat limiting, as the recommendations do not deal exclusively with a code of conduct, but include provisions relating to member state regulation of the not-for-profit sector as well. We recommend revision of the title to reflect the broader purpose of the document.

Definition of NPO

It is important that the organizations targeted by the *Draft Recommendations* be clearly defined. The *Draft Recommendations* define “non-profit organizations” as “organisations, legal or natural persons, legal arrangements or other types of body that ‘engage in the raising and/or disbursing funds for charitable, religious, cultural, educational, social or fraternal purposes, or for the carrying out of other types of good works.’” (*Draft Recommendations*, page 1).⁵ Given the *Draft*’s purpose in countering abusive practices, it is not surprising that it takes an approach of covering a wide range of organizations and individuals. However, this definition is at odds with the understanding of the term “NPO” in most Member States, and as a result, once the *Draft* turns to issues of Member State law and regulation, the definition becomes unworkable. Specific problems include:

- a) The inclusion of “natural persons” in the definition of non-profit organizations. NPOs are typically legal, not natural, persons – organized as foundations, associations, charities, and other forms specifically provided by law. The inclusion of natural persons in the definition renders many of the recommendations confusing. To take but one example (discussed more fully below), in Section A.1, the *Draft* recommends that Member States “operate publicly accessible registration systems for all NPOs operating on their territory.” Registration is the process used to convey legal personality to an NPO, and if “NPO” is understood as embracing legal persons, this recommendation is sensible and non-controversial. If the term NPO is understood as including natural persons, however, the recommendation is confusing, as natural persons typically do not register under the laws of the Member States. To the extent that the definition is meant to embrace officers and board members of organisations in their individual capacity, it requires clarification, as such persons typically would not be held responsible as individuals for the organization’s acts.
- b) The inclusion of businesses and other for-profit organizations. There is nothing in the definition to limit the coverage to non-profit organizations only. Instead, for-profit businesses could be covered by the definition, as it is not uncommon for corporations to engage in philanthropic initiatives or community development projects. Indeed, corporate matching gift programs, under which corporations match the small donations their individual employees make to local charities, fall within the reach of the definition. For-profit companies that raise funds for charities for a fee would also be covered. These types of organizations also do not typically register using “NPO” forms of organization and are not regulated as such.
- c) The limitation to a subset of not-for-profit organizations. NPOs generally undertake a wide range of activities, some of which benefit the public, and some of which benefit only members of the

⁵ We understand that this definition is based in part on the definition contained in the FATF Special Recommendation VIII Best Practices Paper. The definition contained in the *Draft Recommendations*, however, broadens the concept in such a way as to invite confusion, as is spelled out in detail in the text.

organization. The definition provides, arguably, for only a subset of the non-profit sector – public benefit organizations or charities. This limited conception of NPO leaves out many membership associations, which make up a large part of the associational life in any country – thus defeating in large part the purpose of the recommendations. It may be that the phrase “social or fraternal purposes” was intended to include mutual benefit organizations, but if so, this should be clarified.

Section A.1. – Oversight Mechanisms

Registration. The *Draft Recommendations* state that the oversight role of a competent state authority with respect to NPOs should include operating “a publicly accessible registration system for all NPOs operating on their territory, wishing to take advantage of preferential tax treatment . . .”

Registration generally is the process that establishes the legal personality of an entity, and carries with it the benefits typically associated with legal personality, e.g., limitation of individual liability for the entity’s acts. It applies to organizations with a wide range of organizational purposes.

By contrast preferential tax treatment and eligibility for public funding is often available to a smaller subset of organizations, those that work for the public benefit as defined by particular national laws.

The registration system, and the need for public access to it, should be available to all types of not-for-profit organizational forms, and should not be limited only to those wishing to take advantage of tax preferences.

The *Recommendations* should be carefully reviewed to ensure that they do not suggest that registration should be mandatory for groups carrying out certain types of activities. To begin with, no EU Member State makes registration mandatory; informal (i.e., non-registered) groups and organisations are fully able to carry out activities, including activities for the public benefit. Furthermore, in some countries, there is no government registration requirement per se; in the Netherlands, for example, the association and foundation are both established by notarial deed and then have full legal capacity. In our view it would be inconsistent with the European Convention on Human Rights (ECHR) and the constitutional right to freedom of association enshrined in all constitutions of the Member States to require mandatory registration of NPOs, which although not explicitly stated, seems to be a desired objective of the *Recommendations*.

Assessment of Risk of Abuse. We suggest that this provision should be drafted to include reference to appropriate limitations on the power of the competent authority (both substantive and procedural) to request information from an NPO.

Audits by the Tax Authorities. While tax audits may be appropriate in certain circumstances, where risk assessment systems suggest the need, the primary means of ensuring compliance is normally through reporting requirements.

Section A.4. Investigation of Abuse by Non-profit Organizations

We commend the drafters for recognizing that the “investigation should be proportionate to the weight of identified risk.” We suggest, however, that this provision should additionally include specific statements regarding procedural safeguards for NPOs and appropriate limitations on the power of the competent authority to investigate an NPO.

Section B. Code of Conduct

Basic Identification Form. The code provisions contemplate that organizations will file a “basic identification form.” This requirement appears nearly identical to the establishment act and governing statute that NPOs must file upon registration in most countries. The code should not be read to impose duplicative or conflicting requirements on NPOs, particularly where they are generally already a matter of Member State law. Codes of conduct generally do contain standards that require NPOs to adhere to the requirements of law, and this type of provision should be sufficient to ensure that NPOs comply with their national registration and other legal requirements.

Bookkeeping and financial statements; audit trails. Similarly, in many European countries, the filing of annual financial and activity reports, establishment of internal financial controls, and the retention of records for five years are also required of NPOs or at least of some category of NPOs, usually including public benefit organizations, or larger organizations. The proposed code should not attempt to impose requirements that may conflict with these requirements. Moreover, the terms “proper bookkeeping” and “audit trails” are unclear without further definition or reference to specific laws establishing requirements for maintaining financial records. In addition, reporting is also not required in all countries, even of public benefit organizations. In Hungary, for example, public benefit organizations must prepare and make accessible – but not submit - an annual report.

Weak and Inadequate Standards. Given the gravity of the concern addressed by the code of conduct – to protect the NPO sector from exploitation for the financing of terrorism and other kinds of criminal abuse – the code could be strengthened by the inclusion of additional provisions. Its proposed terms, as highlighted above, are largely a repetition of already existing legal requirements (or a proposed additional system of registration and accountability), and add little that might aid NPOs in establishing the strong governance and management that would render them less susceptible to abuse.

The proposed code lacks several fundamental issues, including the following:

- a) Any requirement that NPOs must pursue the statutory-based, mission purpose of the organisation, and not use their resources for other purposes.
- b) A provision placing responsibility for legal compliance with the highest governing body of the organisation.
- c) More specific criteria relating to fiscal responsibility for those NPOs providing charitable resources. This point is critical. The Code does maintain that “All NPOs should follow the ‘Know your beneficiaries, donors and associate NPOs’ rule”, but does not provide more detailed guidance as to how to accomplish this. For example, the Code could require that the NPO should, in advance of payment, determine that the potential recipient has the ability to both accomplish the charitable purpose of the grant and protect the resources from diversion to non-charitable purposes; the NPO should reduce the terms of the grant to a written agreement; the NPO should engage in ongoing monitoring; and the NPO should seek correction or any misuse of resources on the part of the recipient.
- d) Any provision dealing with conflicts of interest and how to guard against conflicts of interest.

One possible approach to improve the listed standards is to examine the “Risk Indicators” identified in the Annex and ensure that the Code’s standards properly address and guard against the risks stated.

Annex

The “Risk Indicators” themselves should be re-examined. Based on the work of ECNL and its partners in Central and Eastern Europe over the past ten years, several are arguably not appropriate indicators for NPO abuse, especially in the new Member States.

a) Due to the lower level of institutional and professional development of NPOs in the new EU Member States, many of the organizational, management and financial management risks identified are quite common for NPOs but are not necessarily indicative, even if taken together, of any connection to terrorist financing or criminal purposes. For example, under Section A, three of the risk factors (“The NPO shares its registered office with other organisations”; “Manager/Directors/trustees hold positions in other NPOs ...”; “The internet website of the NPO has not been updated in the last 12 months”) may apply to the majority of registered NPOs in Hungary.

b) In other cases, the risk indicators point to issues that arise from the very nature of NPOs even in the more developed Member States. For example, the indicator that "the number of people employed by the NPO are inconsistent with the amplitude of activities" seems to overlook that the majority of NPOs depend on volunteers and are assisted by members and supporters in their daily work, and thus have substantially less need to employ staff to fulfil their mission as compared to for-profit or state-run organizations.

c) Finally, several of the risk indicators focus on the failure of the NPO to comply with certain legal requirements (e.g., “The organization is not registered ...”; “no annual financial statements, no external audits are prepared”; “No clear audit trail can be provided on any given transaction”). In many countries, however, these requirements are in fact not legal requirements, and the failure to carry out these actions is in no way indicative of abuse.

We understand that it is of key importance to identify appropriate risk factors and their indicators related to NPO operations. We would therefore suggest a more nuanced approach and refinement of these indicators and their applicability so as to ensure a connection between the risk indicators and potential terrorist financing and other forms of abuse.

Conclusion

The European Commission is to be commended for its efforts to balance the challenges of regulating NPOs consistent with SR VIII against the need to avoid over-burdening the sector and to foster its growth and development. As raised in the foregoing comments, however, there are several overarching issues – as well as more specific concerns – that deserve further consideration. ECNL respectfully suggests that the EC continue to consult closely with the NPO sector on what kind of response, including a self-regulatory initiative, may be appropriate to promote transparency and accountability and to prevent the dangers of abuse.