

# Legal implications of tokenization in global trade

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## MEMORANDUM



To: Windesheim University of Applied Sciences  
From: RSM Netherlands Business Consulting Services B.V.  
Date: January 19, 2023  
Subject: Research on the Legal Implications of tokenizing physical assets in supply chains.

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Windesheim University of Applied Sciences issued a call for proposals from external experts with knowledge of the legal aspects of blockchain technology. It involved a research project on the legal implications of tokenizing physical assets in supply chains, including the transfer of legal ownership through a blockchain platform. Windesheim evaluated the proposals submitted by different parties and chose RSM. For the following report we have considered the scope defined in the call for proposals, taking as reference the conceptual platform TradeTwin.

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## 1. INTRODUCTION

### 1.1. Legal implications of NFTs in global trade

Windesheim University of Applied Sciences is currently exploring how blockchain based platforms can help producers, borrowers and financiers conduct (local or international) in a secure, transparent, and efficient manner.

The concept is centered on using blockchain to register every step in the production process of the goods from raw materials to end products and to create a NFT from it. The product and its NFT can also serve as raw material for a subsequent product and NFT. These tokens can be split (to represent only a portion of the batch) and recombined with others to form new products, to map the entire supply chain in a reliable (tamper-proof) register.

Such NFT has also the intended purpose of acting as a representation of the goods and mean of exchange, in order for the parties to transfer the ownership of the goods by transferring the NFT. On those grounds, the NFT could potentially be used to back up loans (on fiat currency) taken to finance goods produced through the aid of the platform.

Within the Interreg NEW Blockstart project<sup>1</sup>, various concepts were identified and analyzed with participating SMEs, in which tokens represented specific goods in supply chains (organic and non-organic). Main focus of the conducted studies was to clarify the business model feasibility, without exploring the legal aspects in detail. With this legal study, Windesheim aims to get a better understanding of the legal nature of the NFTs created through a conceptual platform called TradeTwin, to determine if they can actually be used as intended, with legal the consequences and status that users of the platform require.

### 1.2. TradeTwin - Use case scenario

To facilitate the study of the platform, we will consider the following use case scenario:

1. Before using the platform, users will need to agree to its general terms and conditions, which will be mandatory, legally binding, and cannot be overridden without explicit consent of the manager of the platform.
2. Farmer A produces milk and makes cheese while registering every part of the transformation process on TradeTwin.
3. The whole process, including the transformation from milk to cheese, is cryptographically tracked and tokenized, and eventually merged into one NFT to grant property and security rights.

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<sup>1</sup> <https://www.nweurope.eu/projects/project-search/blockstart/>

4. An UK established company B wants to buy the cheese and request a loan from Financer F. They conclude the negotiations. The loan is provided in Euros, outside TradeTwin.
5. B pays the money (Euros) to farmer A, outside TradeTwin.
6. The NFT is set as a digital representation of the collateral to back up the loan.

### 1.2.1. Scope of research and questions

The main topic to explore is the legal enforceability of the obligations acquired (in the international trade context) through the tokens generated through TradeTwin. To that end, we will answer the following questions and sub questions:

1. *Do Non-Fungible-Tokens NFTs confer legally enforceable claims to the goods in the context of international trade? If so, to what extent?*
2. *And what is legally required to that end? If not, what would need to change legally?*
3. *What is the current position of the Dutch and English Law in relation to the legal enforceability of the obligations acquired through NFTs?*

The research questions are of legal nature. The questions, therefore, must be answered through doctrinal research, where the most relevant theories of property and contract law, together with relevant jurisprudence, are going to be studied. The answer, however, will be provided in clear non-legal language. Given the limited scope of the project, only the legislation of the Netherlands and the United Kingdom have been chosen. The aim is to find a clear answer in the current Dutch and UK law. Where no such answer exists, we will explore to what extent (and subject to what limitations) the stakeholders can set up their own legal regime through contracts. In sum, we will study if NFTs confer property rights to the goods they represent, if they can be conceived as negotiable instruments that embody a legal claim to demand the delivery of the goods. In case none of the above is legally admissible, we will explore alternatives through which the abovementioned ends could be achieved.

### 1.2.2. Definitions

In this report, the following definitions will be applied:

Item	Description
<b>Hold:</b>	Have exclusive control over a thing, without necessarily claiming ownership over it. A holder holds the thing on behalf of the owner.

<b>Possess:</b>	Have exclusive control over a thing, while claiming property rights over it.
<b>Own:</b>	Be legally vested with property right over a thing. The owner does not need to hold the thing he owns.
<b>Obligation:</b>	A legally enforceable promise. It may entail to give something (e.g. money), to do something (e.g. deliver the goods), or not to do or give something
<b>Obligor:</b>	The person who owes an obligation, or who is legally charged with its fulfillment.
<b>Obligee:</b>	The beneficiary to whom an obligation is owed.
<b>Assignor:</b>	The person who relinquishes the exclusive control (hands over) over an NFT through the relevant digital platform. Whether the reassignment of the NFT comes with the transfer of property rights, depends on the preceding contractual arrangement. If the preceding contract is a sale, the property would be transferred, while a contract for warehousing or transport would be unfit for that purpose.
<b>Assignee:</b>	The person in favor of whom the exclusive control over an NFT is relinquished through the relevant digital platform, with or without the transfer of property rights.

The premise on which the whole project rests is that electronic documents are valid and legally enforceable. The possibility to identify the issuer of a given document is a necessary condition to that end. This is achieved (among others less effective and uncertain means) through a signature. That holds for both the Netherlands and the UK.

In the case of the Netherlands, article 3:15a BW (Dutch civil code) confers legal value (equal to that of a wet ink signature) to “qualified electronic signatures”<sup>2</sup> issued according to article 3.12 of EU Regulation 910/2014 (eIDAS), that is by means of a trust certificate issued by an authorized trust service provider.

The UK also widely recognizes the validity of electronic documents with “qualified electronic signatures”. The Law Commission issued a statement on this regard, ratifying that Regulation 910/2014 remained part of the UK domestic law after the withdrawal of the UK from the EU<sup>3</sup>.

Hence, the documents (including smart contracts) to which we refer in this report are assumed to carry a qualified electronic signature with which the identity of the issuer can be legally established with certainty.

<sup>2</sup> A ‘qualified electronic signature’ is defined as an advanced electronic signature that is created by a qualified electronic signature creation device, and which is based on a qualified certificate for electronic signatures

<sup>3</sup> The report can be accessed via <https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2019/09/Electronic-Execution-Report.pdf> Page 34 deals with qualified electronic signatures.

## 2. NFTS AND PROPERTY RIGHTS

### 2.1. Property rights and the transfer thereof

The question of whether NFTs can serve as “carriers” of property rights over movable goods (whether an NFT embody the goods) has a similar answer in English and Dutch Law. Property rights are expected to be enforceable universally, i.e. against every single person. That end can only be achieved through law, not through contracts because the effects of contracts are limited to the parties therein. Hence, the possibility that the goods are represented by a NFT, whose possession represents the ownership of the goods as such, has no grounds on the current Dutch or English Law.

Even if two parties agree to such a means of exchange, those contractual clauses would have no effect on third parties; that is to say, would not be enforceable universally. For that purpose, a general law would be required.

English law does not acknowledge that construction (or legal fiction) around NFTs, however, the UK Parliament has opened an inquiry to gather evidence from the public around an upcoming NFT regulation<sup>4</sup>. The law in the Netherlands does not give that status to NFTs, nor has a proposal been presented to the competent lawmakers. A different issue is the transfer of the property rights that one has over specific goods. Both jurisdictions differ on the requirements to transfer the property.

### 2.2. Transfer of property in Dutch law

According to Dutch property law, the mere sale of goods does not suffice to transfer the property. The law requires that the goods be also delivered. Therefore, the sale of the goods operates as the *title* on basis of which, the property could be transferred; and the delivery of the goods is the *modus* in which the property is transferred. Both the *title* and the *modus* are required<sup>5</sup>. Delivery (or handing over) without a sale (for instance, for transportation or warehousing purposes) is unfit for transfer of property in favor of the receiver.

The aforementioned constitutes the general rule, to which the law<sup>6</sup> grants three exceptions that are relevant to this project. In the following scenarios the goods can also be transferred without physical delivery of the goods:

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<sup>4</sup> <https://committees.parliament.uk/call-for-evidence/2966/>

<sup>5</sup> This is determined by articles 3:83 and 3:84 of the Dutch Civil Code (Burgerlijk Wetboek or BW), together with article 3:90.

<sup>6</sup> Article 3:115 BW



- a) The seller is in possession of the goods and the parties agree to letting the seller hold the goods on behalf of the buyer.
- b) The buyer was already holding the goods on behalf of the seller, by the time of the sale.
- c) A third party was holding the goods on behalf of the seller, and after the sale, he now holds them for the buyer<sup>7</sup>.

In theory, under Dutch Law, parties could agree that the transfer of possession takes place via the option explained in letter a) by means of a digital or smart contract completed with the reassignment of a NFT. However, it should be noted that the mere reassignment and holding of a NFT has no legal meaning on its own. What transfers the property is the sale contract (*title*) supplemented with the special clause described under a) and not the reassignment of the NFT. In the Netherlands, the NFT could serve as the vehicle through which the parties conclude a sales contract. If that agreement does not exist, the reassignment of the NFT through the digital platform has no legal consequences.

### 2.3. Transfer of Property in the UK Law

In the UK, according to section 16 of the Sale of Goods Acts 1979, the transfer of property through a sale contract requires, in some cases, the delivery of the goods to take place. It depends on whether the object of the contract is the sale of specific goods<sup>8</sup> or goods that have already been ascertained by the buyer<sup>9</sup>. In that case, the property of the goods can be transferred to the buyer whenever the parties agree, with or without delivery. Otherwise, the law requires that the goods be ascertained.

Whether goods are specific and/or ascertained, needs to be assessed on a case-by-case basis, taking into consideration the circumstances surrounding the case. Since one of the main functionalities of the platform is that goods are described thoroughly (step by step and in relation to their composition), they should be considered specific goods, in principle. However, that determination depends on the degree to which the goods have been processed. In that sense, cheese thoroughly described in the platform could be considered a specific good, but that is hardly the case for fresh milk, for instance. In any case, the transparency and reliability provided by TradeTwin plays an important role in this aspect.

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<sup>7</sup> Refer back to the definitions of “hold”, “own” and “possess” in section 2 of this document.

<sup>8</sup> “specific goods” means goods identified and agreed on at the time a contract of sale is made, according to article 61 of the Sale of Goods Act 1979.

<sup>9</sup> Unascertained goods are generic or future goods; also, goods that have not been seen by the buyer. The Law Commission of the UK in <https://researchbriefings.files.parliament.uk/documents/CBP-9036/CBP-9036.pdf> page 21, clarifies that goods sold online are examples of unascertained goods, while goods bought at a physical store are ascertained goods.



Therefore, the property rights of the goods could be transferred at the moment the sale contract is concluded in the platform. As previously stated for the Dutch Law analysis, nothing prevents the parties to agree to use the NFT as the vehicle through which the contract is concluded.

### 3. NFT's as negotiable instruments

There are some instances in which the goods seem to be *represented* by a document. That is the case, for example, with certificates of deposit (also known as “warehouse receipts”) and documents of transport (bill of lading).

However, as van der Lely explains<sup>10</sup>, the reality of this legal treatment is not that the goods are represented by the document but rather that the document (*waardepapier*) embodies an obligation (a legal claim or a *vorderingsrecht*). This legal claim entails the obligation of the issuer (the representative of the warehouse in the case of the certificate of deposit, or the carrier for transportation contracts) to deliver the goods to the holder of the document. It is important to note that the document may be exchanged thereby changing the obligee (creditor), but the obligor<sup>11</sup> (the issuer) remains stable throughout the commercial cycle of the document.

Those documents are closer to a negotiable commercial paper (instrument) than to an actual legal representation of the goods. Being in possession of the paper does not mean being the rightful owner of the goods; rather, it represents a claim against the carrier or warehouse (obligors) for them to handover the goods.

In this section 3, we will explore to what extent can NFTs be legally deemed to constitute a (*sui generis*) type of negotiable instrument.

The main legal issue that arises with negotiable instruments in electronic form is the problem of possession. In the past, before the rise of blockchain technology, legal scholars and courts agreed that it was not possible to conceive negotiable instruments in electronic form because they could not be possessed exclusively by one and only one party<sup>12</sup>.

Ordinary electronic documents could be copied easily with no unsurmountable restriction. Blockchain has revolutionized the legal understanding of the electronic world in the sense that it is now possible to exercise exclusive control over an original (unique) electronic document. However, all the regulations, doctrines, jurisprudence and the whole legal infrastructure are built around the idea that only physical paper-based documents can be **possessed**, in the legal sense.

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<sup>10</sup> Levering van roerende zaken door middel van een zakenrechtelijk waardepapier, University of Groningen, 1996

<sup>11</sup> In this context, the term “debtor” is used in a broader sense to mean the person who must fulfill an obligation, namely, the obligation to deliver the goods.

<sup>12</sup> See for example, Graaf, T. J. de. (2002). Elektronische waardepapieren. In P. J. E. J. Esch R.E. van (Ed.), *Recht en elektronische handel* (pp. 161-174). Deventer: Kluwer. Retrieved from <https://hdl.handle.net/1887/47267>

### **3.1. Electronic negotiable instruments in the Netherlands**

Article 3:93 BW establishes that documents of title (such as certificates of deposit or cheques) can be transferred through the delivery of the document, according to article 3:90, 3:91 and 3:92 BW. This delivery takes place by conferring possession of the goods (in this case, the document) to the acquirer. Whether this possession can take place digitally has not been settled by Dutch legislation nor by jurisprudence.

It is noteworthy, however, that the United Nations Commission on International Trade Law UNCITRAL has been pushing in that direction and even adopted the Model Law on Electronic Transferable Records (2017) which is based on the principles of technology neutrality and functional equivalence<sup>13</sup>. For now, the legal recognition of the digital possession and delivery that takes place with NFTs remains an open issue in the Netherlands<sup>14</sup>. Therefore, we cannot recommend that TradeTwin be based on that model.

### **3.2. Electronic negotiable instruments in the UK**

The negotiability of commercial instruments in the UK stems from the law and is thereby regulated. Negotiability of a document of title entails that the “Holder in Due Course”<sup>15</sup> can acquire the document free from any defect stemming from the right of the transferor. A negotiable document is, therefore, independent from any previous transactions that could have been the cause or the occasion for its emission. One who acquires a negotiable instrument in the UK, acquires an irrevocable, unconditional, legally enforceable, promise to pay that he can further transfer without special formalities. As a result, no defense to non-payment can be opposed to a holder in due course, even if the document was obtained by the transferor by means of fraud, duress, force and fear, or other unlawful means.

The main issue with conceiving NFTs as an electronic negotiable title in the UK is that the governing law thereof is the Bill of Exchange Act from 1882. That body of law has not been updated to incorporate any consideration to digital instruments. In fact, there was a reform to allow negotiable instruments to be presented by payment by digital means (image of both faces of the instrument) but it only confirmed that digital instruments may only exist physically.

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<sup>13</sup> Takahashi, Koji and Takahashi, Koji, Blockchain-based Negotiable Instruments (with Particular Reference to Bills of Lading and Investment Securities) (October 6, 2021). to be published (subject to formatting and copy-editing) as a chapter from Andrea Bonomi and Matthias Lehmann (eds) Blockchain & Private International Law (Brill), Available at SSRN: <https://ssrn.com/abstract=3937664>

<sup>14</sup> It is also worth mentioning that an open consultation was carried out for the proposal Wet Invoering Elektronisch Vervoerbepaling, to digitize the Bill of Lading. It is a decisive step in that direction.

<sup>15</sup> i.e. the person who acquires a document in good faith, for value, in full (not a share on it), without being aware of possible defects stemming from the rights of the transferor

In addition, negotiation (i.e. the transfer of the document from person to person) requires delivery of the instrument (both payable to bearer and payable to order) and this is only achieved through the transfer of possession, as stated in section 31 of the Bill of Exchange<sup>16</sup>. Without this physical possession, the document is not negotiated and cannot be presented for payment.

To be clear, both Dutch and English Law recognize legal value to electronic documents and allows digital documents to be digitally signed<sup>17</sup>. The problem lies in the **possession** of documents that is required for negotiable instruments to be effectively transferred. In the case of the UK, this assertion was also acknowledged by the UK Law Commission, on basis of which they presented a bill to the UK Parliament to amend the law to *allow digital possession of documents*, on the condition that an absolutely reliable technology ensures *exclusive control by one and only one party*<sup>18</sup>. On those grounds, until the proposed legal reform is in force, we cannot recommend TradeTwin to be based on that model in the UK.

In sum, NFTs cannot constitute negotiable instruments in light of English Law because they cannot be possessed (this conclusion is also applicable to bills of lading and warehouse receipts). Therefore, they cannot benefit from the features that stem from negotiability. However, that does not mean that that NFTs cannot be used in (global) trade to facilitate financing and secure the exchange. In the next section, this construction will be studied.

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<sup>16</sup> International Trade and Forfaiting Association ITFA, “The ITFA Digital Negotiable Instruments Initiative”, 2021, page 32.

<sup>17</sup> International Trade and Forfaiting Association ITFA, “The ITFA Digital Negotiable Instruments Initiative”, 2021, page 17.

<sup>18</sup> See also <https://www.lawcom.gov.uk/project/electronic-trade-documents/> for information on the consultation process opened by the UK Law Commission and the draft proposal presented to the UK Parliament on October 12<sup>th</sup> 2022.

## 4. PROPOSED ALTERNATIVES

### 4.1. Introduction

Up to now it has been established that NFTs are a technically viable alternative to create electronic negotiable instruments, however the legal infrastructure (i.e. legislation, jurisprudence and doctrine) is not ready yet. Hence, they cannot be implemented with sufficient certainty.

Also, they cannot represent the goods themselves to constitute property rights in favor of the holder; however, they can serve as the vehicle through which the property rights are transferred (using the right contractual arrangements). Now contract law will be explored to determine to what extent can NFTs be used to represent contractual claims (irrevocable, unconditional, and legally enforceable with no admissible defense to non-payment) to the property of goods.

First, in negotiable instruments, the identity of the **obligor** (the person legally obligated to fulfill an obligation) is of the essence; it cannot change as the document circulates in the market. What we see is one credit with one **fixed** obligor (the issuer) and one **interchangeable** obligee (beneficiary of the obligation). Whoever the obligee is, its claim with regard to the document will always be directed against the issuer of the title (i.e., the obligor). The flow can be described as a title issued by A in favor of B; if B transfer the instrument to C, then it would be a debt between A and C; if C subsequently transfers the instrument to D, the debt would be between A and D; and so on. A remains stable in the equation as the title circulates. This is incompatible with the legal flow that we see in the supply chain.

From the use case scenario, it can be seen that the NFT is intended to switch hands along the supply chain; but, it is crucial to note that the reassignment of the NFT does not only entail the change of the obligee (the person entitled to receive the goods), but also the change of the obligor (the person charged with delivering the goods).

Such legal flow can be better described as a *succession of independent contracts* rather than one single debt circulating among the participants of a given supply chain. The obligation would originally involve A and B; if B sells the goods to C the claim would bind B to C; if C sells the goods to D, the obligation would be between C and D; and so on. This entire flow, from the producer to the intermediaries, the transportation company, the warehouse, to the buyer (B2B), cannot be achieved through negotiable instruments.

### 4.2. A succession of independent contracts

A platform as described in the introduction needs to be able to represent the reality of the supply chain flow and also account for the legal obligations that arise with every move in the chain. To that end, we propose to use a NFT with irreversibly embedded data (metadata) in the form of natural language forming clear and straightforward contractual clauses that confer a right to receive goods from the assignor<sup>19</sup> (i.e., the previous holder of the NFT).

In doing so, by reassigning the NFT, the assignor would also acquire the obligation to deliver the goods. As soon as he does, his obligation would be fulfilled and the rights of the (new) NFT holder would be exhausted. The proposed text embodied in the NFT is as follows:

- By reassigning this token, the assignor acquires an irrevocable obligation towards the person to whom the token is reassigned (assignee).
- The obligation consists of the immediate delivery of the goods hereby described to the assignee.
- The obligation will be fulfilled when the goods are delivered and will cease to exist if and when the assignee subsequently reassigns the token.

#### **4.3. NFTs to back up a loan in international trade**

In a typical supply chain flow, according to the model hereby described, the NFT must circulate together with the goods: from the producer to the carrier, the distributor, the warehouse, etc. On the other hand, ideally, the collateral must stay with the lender until the moment the debt is paid in full. If the digital platform is to mirror the flow of the goods in the reality, the NFT representing the goods cannot stay in (digital) possession of the lender.

It is therefore unfeasible to use one single NFT to track the flow of the goods through the supply chain and stay with the lender to serve as collateral at the same time. A different solution must be devised.

It was already established that the legal structure does not currently support the use of NFTs (or any digital document) as negotiable instruments. On those grounds, the loans cannot be backed up by NFTs acting as negotiable instruments. However, regular contracts and registers generated on a platform can still be used to secure the proper and mutual execution of the promises the parties to each other in the context of a loan agreement.

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<sup>19</sup> The goods could be fungible (interchangeable with other of the same technical characteristics) or non-fungible, meaning a concrete batch. The main legal difference arises if the goods perish. In the case of non-fungible goods, the legal obligation could also be extinguished along with the goods, provided other conditions are met.

Admittedly, a loan agreement signed with a Qualified Electronic Signature QES does not have the same legal force as a negotiable instrument<sup>20</sup>; however, the use of a blockchain based platform offers the parties a transparent environment whereby obligations (including all their surrounding circumstances) can be proved with certainty, if they ever need to be enforced in court or arbitration.

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<sup>20</sup> Negotiable instruments form an irrevocable, unconditional, legally enforceable, promise to pay, to which no defense to non-payment can be opposed.



## 5. Conclusion

Under this conception, the NFTs are merely vehicles through which the contractual obligations are acquired and proved. In that capacity, they are not qualitatively different from traditional paper-based contracts. The benefits stem from the efficiency, transparency and the readiness with which obligations can be acquired and proved, even in the international context. In this line, the use of qualified electronic signatures by all the users of the platform is crucial.

It is important to keep in mind that they are not negotiable instruments, therefore, the ordinary provisions of contract law apply. As a consequence, there could be legally admissible defenses to non-payment (in this case, non-delivery of the goods). For instance, even if one participant currently holds the NFT and sues his assignor (demanding the delivery of the goods), the assignor could still deny payment based on the circumstances of the transaction (e.g. he did not receive full payment from the assignee).

Finally, according to article 3 of the Rome Convention<sup>21</sup> to which both the Netherlands and the UK have adhered and ratified, parties are free to choose the law that shall govern their contract (in its entirety or only a specific part). The platform herein described can adopt (in its general use terms and conditions) either the Dutch or the English Law as the applicable law to resolve the conflicts that may arise between the users.

Both legislations contain similar features (in a sense relevant for this project), however, it is worth noting that the distinction between *unascertained* and *specific goods* in the UK could be an obstacle to the transfer of property rights by electronic means. That decision needs to be taken into the general terms and conditions of the platform. The users will have to accept these terms and conditions to take part on the platform, and they need to contain clauses that cannot be overridden by the private agreements of the users, without explicit consent of the manager of the platform. The choice of law is one of those clauses.

After studying the platform and its functionalities, we see potential for additional use case scenarios, other than making trade more secure and efficient. For instance, the absolute transparency and reliability with which every step of the production process (including the origin of the goods, the identity of the producer) is recorded could be of great benefit in the context of the upcoming ESG reporting obligations in the European Union.

The regulatory focus is to incorporate sustainability requirements into the supply chain. The Corporate Sustainability Reporting Directive, for instance, will implement an obligation for businesses to disclose substantial

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<sup>21</sup> Convention on the law applicable to contractual obligations opened for signature in Rome on 19th June 1980

information with regard to environmental protection, human rights, and labor standards. In a similar way, the new proposal for a regulation on a Carbon Border Adjustment Mechanism CBAM mandates importers to disclose the emissions embedded in the products that they bring into the European market. Additionally, the EU agreed on new regulations to fight off deforestation worldwide, with strict reporting obligations regarding the origin of commodities<sup>22</sup>.

The tool that we have studied could be used by potential buyers (B2B) in the European market to screen their suppliers in advance to facilitate the making of a sustainable choice. Not only that, but opting for a supplier with sustainable practices, in the context of CBAM, will also have direct repercussions on the amount payable upon import (in the form of CBAM certificates).

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<sup>22</sup> [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_22\\_7444](https://ec.europa.eu/commission/presscorner/detail/en/ip_22_7444)