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Human Rights Due Diligence and Sustainable Supply Chains

Insights from FTI Consulting Europe, US and Asia

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The European Union is expected to shortly roll out new legal obligations which could include civil liability for human rights abuses and environmental harm in supply chains. This has important implications for European businesses working in a globalised economy across almost every industry; from fashion brands sourcing from textile factories in South Asia, major technology companies reliant on rare metals mined in Africa or food brands using ingredients farmed in Latin America, for example. The climate emergency and the COVID-19 pandemic have accelerated the need and demand for a more sustainable future. FTI Consulting looks at how mandatory human rights due diligence in supply chains has gained urgency, how Europe is responding and what companies should be doing.

What is the issue?

The European Commission announced in April that it will introduce legislation on Mandatory Supply Chain Due Diligence. This should shed more light on extended parts of corporate supply chains, seeking to create more sustainable and resilient business practices and to leverage the influence of European companies to improve the livelihoods of people around the world. The regulation will require companies to assess, report and possibly remedy the impact of their business operations on human rights and the environment throughout their supply chains, including amongst suppliers and sub-contractors, wherever they may be. Modern business

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models for global corporations can include many different elements within their supply chains, from raw material extraction, to refining, production of components and

assembly, that can take place across multiple jurisdictions, before the product reaches consumers. Every step of these supply chain could include potential breaches of human rights and environmental degradation, under European law, that may or may not be accurately accounted for. The COVID-19 pandemic has highlighted the challenge, with many companies reliant on informal labour in poorer and potentially less regulated markets, that has become more difficult to source as countries introduce measures to compact the virus.

Most global corporations have supply chain due diligence in place to address human and labour rights abuses and environmental harm. In many circumstances, this is a voluntary process, and the quality and enforcement of any standards may be less robust if it concerns contractors and third parties engaged by global corporations. In many sectors, voluntary industry codes are one way for global corporations to ensure that suppliers comply with mandatory requirements, but it is difficult to enforce these measures uniformly across the globe. Mandatory due diligence for European business aims to influence upstream sectors, turning high human rights and environmental standards to a competitive advantage. Once implemented, such rules could also serve as a technical trade barrier, giving advantage to suppliers from countries with higher standards of governance and human rights.

Road towards mandatory due diligence

The announcement to introduce binding legislation by Didier Reynders, the EU Commissioner for Justice, came after many years of discussions and developments at global and Member State level.

Global level

The UN has been a front runner on supply chain due diligence. In 2005 it started a process that led to the [Guiding Principles on Business and Human Rights \(UNGPs\)](#) which today are considered the key framework for responsible business conduct. The UNGPs define supply chain due diligence as a central element of responsible business conduct and set minimum criteria for companies and governments.

Since the adoption of the UNGPs, the UN has engaged in many activities such as the [Accountability and Remedy Project](#) aimed at enhancing accountability and access to remedies in cases of business involvement in serious human rights abuse and coordinating an intergovernmental working group that works towards an international binding instrument to regulate the activities of business in relation

to human rights. With the annual UN Forum on business and human rights the UN organises the largest event on the issue globally. On 7 July the UN, together with the German Council Presidency, also launched the [UNGP next 10 years](#) project, a roadmap and vision to ensure broader implementation of the UNGPs by 2030.

The [OECD Guidelines for Multinational Enterprises \(MNE\)](#), aim to ensure that the operations of companies contribute to sustainable development, including the protection of human rights. Due diligence is one of their central recommendations to business. In 2018, the OECD published its [Due Diligence Guidance for Responsible Business Conduct](#) to help companies complying with the Guidelines for MNEs and thereby avoid and address adverse impacts related to workers, human rights, the environment, bribery, consumers and corporate governance that may be associated with their operations, supply chains and other business relationships.

EU and key Member States:

Europe was the first continent that started to act on the issue, following the collapse of a garment factory in Bangladesh that supplied many western countries. The incident resulted in over 1100 deaths and more than 2,500 injuries.

- **United Kingdom** was a frontrunner, adopting the Modern Slavery Act in 2015 that requires companies to report on due diligence on modern slavery.
- **France** adopted in 2017 the [Duty of Vigilance Act](#), the most far reaching legislation so far. The law requires large multinational companies to have human rights due diligence in place. If this is not the case, organisations with a justified interest, such as Trade Unions, can give formal notice and demand the company to fulfil its obligations. If the company has not obliged after three months, it can be sued and forced to pay a penalty. What gives the law real teeth is that companies can be held liable for incidents that happen in their supply chains if they cannot prove that they have an adequate due diligence mechanism in place. Earlier this year the French Economic Council [evaluated](#) what has been achieved so far and concluded that a lot still needs to be done despite the significant progress that has been made.
- In May 2019 **the Netherlands** followed suit and adopted the Child Labour Due Diligence Law. The law requires companies selling goods or services to Dutch consumers to identify and prevent child labour in their supply chains through due diligence. The company needs to affirm this with an official declaration. If a company does not

comply with the requirements and products are being manufactured using child labour, it must rectify the situation in due time. Failure to do so can result in fines or other penalties.

- In the meantime, eleven other EU Member States are working on mandatory due diligence legislation. This includes **Germany**. In 2016 it launched its action plan on business and human rights. It is a broad initiative, involving ten ministries and many different actions. A central element is a comprehensive monitoring exercise to verify whether German companies with at least 500 employees have established adequate human rights due diligence. A first interim report in July 2019, concluded that less than 20% of the companies that have participated in the survey have adequate mechanisms in place. Currently the results are being verified and a final report should be published later this in the summer. While the results so far would support mandatory rules, the German Government has not yet found a joint position. In the meantime, the Federal Ministry for Labour and Social Affairs and the Ministry for Economic Cooperation and Development produced a document outlining the key elements of a potential law on human rights due diligence. The ambitious draft caused strong opposition from within the Government and the business community.
- The **European Commission** has focused in the past on sector specific rules that involve supply chain due diligence such as conflict minerals and forestry. However, following pressure from the Member States that have rules in place and from Trade Unions, NGOs and the European Parliament, the EU has progressed on human rights due diligence.

Most importantly the European Commission published a comprehensive study on due diligence requirements through the supply chain in February 2020. The study found that only one in three businesses in the EU are currently undertaking due diligence which takes into account all human rights and environmental impacts. For Commissioner Reynders this means that voluntary action to address human rights violations has not brought about the necessary change. At a webinar with Members of the European Parliament (MEPs) on 29 April he announced that the Commission will introduce rules on mandatory due diligence as part of legislation on sustainable corporate governance in 2021. The impact assessment is likely to be launched in July 2020 and the European Parliament will draft an Own-Initiative Report with the first draft expected in September.

How could EU new legislation on mandatory due diligence look like?

The Commission study outlines several options, from voluntary guidelines, to reporting requirements and mandatory due diligence. One option would require companies to carry out due diligence to *'identify, prevent, mitigate and account for actual or potential human rights and environmental impacts in its own operations or supply chain'*. Following Reynder's intervention this option is most likely. However, there are still many open questions and variations on how such requirements would work.

The scope

The first question is how wide the scope is going to be. Will the rules be horizontal or sector specific and will they be limited to large companies or also cover SMEs?

Most NGOs and proponents of mandatory due diligence argue in favour of horizontal rules. The European Parliament Working Group on Responsible Business Conduct (RBC) that has become an influential voice in the debate, advocates for covering companies of all sizes and across all sectors that are based, operate or offer products or services in the EU. SMEs that are not engaged in risky activities could take a simplified approach. There is likely to be a strong push-back from business on this position and in the end the legislation might follow the French example and focus on large companies.

Human rights and ...

The second question is whether the rules focus on human rights or are extended to include environmental impacts too. Unlike human rights abuses that are covered in international conventions, environmental impacts are not always as clearly defined in international law and it will be more difficult to develop rules that provide for sufficient legal certainty. Didier Reynders said that the aim of due diligence is to prevent and mitigate adverse human rights and environmental impacts. NGOs and RBCs want due new diligence rules to include obligations to respect human rights as well as the environment. Given the impact environmental degradation can have on health and lives of whole communities and it is more than likely that the rules will reflect environmental impacts. There is an extensive legal debate ongoing on how rules can be designed in order to provide for enough legal certainty.

Sanctions

The most controversial question is what kind of sanctions the rules will impose. Proponents of mandatory due diligence would like the rules to establish civil liability

for human rights abuses and environmental harm. The rules should also provide access to remedy for victims by removing any barriers to justice, for example by shifting the burden of proof. On the one hand civil liability would make due diligence rules very effective and serve as a strong incentive to have comprehensive due diligence in place. On the other hand, the earlier, first stages of the supply chain are very difficult for European business to control in particular if it concerns activities of suppliers and sub-contractors with which the European company has no contractual relationship. Hence there are strong concerns that companies may be held liable for actions committed by third persons, that are outside their influence. It will therefore be very important that the rules clearly define for what abuses European companies could be held liable.

Due Diligence in practice

As stated in our introduction, there is a need for companies to adopt a framework that seeks to identify, prevent, mitigate and account for risks associated with human rights violation. The framework should be informed by the results of risk assessments that are current and subject to periodic review. Companies should seek to identify specific relevant industry and regulatory risks, evaluate relevant markets and competitive considerations, and perform a deep understanding of their business using operational data.

Based on the results of the risk assessment, companies should seek to develop a risk-based compliance programme to address human rights abuses such as human trafficking, part of which would include the adoption of due diligence processes around the hiring of employees and retention of third parties.

Companies should seek to implement hiring and employment controls to avoid human rights abuses. Background searches either using open source or specialised subscription databases should be performed and used to gather information which should be reviewed as part of the hiring process.

From manufacturing partners, distributors and sales agents to consultants and prospective joint venture partners, third parties are often necessary to conduct business around the globe. Properly vetting these third parties is vital to mitigating the risk of human rights abuses both abroad and at home. Companies need to deploy enhanced due diligence practices to detect and prevent for example human trafficking by third party agents and subcontractors

The case for multi-stakeholder approaches

The long-tail risk of non-compliance by suppliers and contractors (who may make up the larger volume of smaller players) who operate in jurisdictions where regulatory and enforcement capacity is weak, are the real concerns for global corporations. Rather than focus on the suppliers as the weakest link, it would potentially be more helpful to re-look at specific jurisdictions and acknowledge that gaps persist due to eco-system challenges specific to each market. Suppliers are simply part of this eco-system. Multi-stakeholder approaches and public-private partnerships are a way to align public and private interests in solving this challenge. Voluntary industry standards are helpful but global corporations must use the economic diplomacy assets at their disposal. They can leverage the impact on investments and local employment to help the eco-system mature to a higher standard. Support from local governments is an imperative for this and for proposing any traceability solution for the supply chain.

that they may employ. In line with the results of their risk assessment and regulatory requirements, there is need for companies to adopt solutions to help manage, execute, document and monitor their third-party due diligence and compliance procedures. Business process and management tools can be procured and customized to help facilitate third-party on-boarding, information, intake, risk ranking, vetting, due diligence assessment approval, ongoing monitoring and renewal of due diligence assessments.

The use of data to optimize the continuous monitoring process cannot be overlooked. In addition to reviewing their own operating data, protective measures such as: anti-human trafficking clauses, term limitations, certifications, and audit rights can provide company's access to third party data for the purpose of compliance monitoring. As a first step, company's need to understand their data environment to identify relevant data sets from accounting and compliance systems.

Next, companies can leverage the use of analytical tools to develop rule-based anomaly detection logic, and where appropriate, predictive analytics to generate insight into

potential patterns or compliance issues. Traceability solutions that track not just the flow of goods but also the participation of labour and environment impact through the global supply and value chains, are critical to addressing these issues. This would allow for executives and compliance personnel to have data at their fingertips to identify key trends over time, displayed by several categories including risk, third-party, and location. The lack of adequate traceability infrastructure, capacity and funding have been key reasons why some of these issues have persisted.

New European legislation: what should companies be doing?

Securing a share of voice

While companies may use sophisticated due diligence processes to review their supply chains, often policy makers have no or little information about them or the operational needs and requirements of a particular company and the specific challenges it may face in identifying and enforcing them. The on-going political discussions and the soon to be launched public consultation on EU due diligence legislation provide a clear opportunity to engage, inform and influence the likely outcome and ensure operational best practice is implemented as part of any new procedures. Similarly, it is important that policymakers understand that a 'one-size-fits-all' approach won't necessarily be practical or implementable. It could also undermine the principles it is seeking to support and damage voluntary initiatives that have already led to improvements on the ground.

Companies should also offer their expertise and share best practices with the EU regulator, showcasing that business is already part of the solution and is ready to engage further in order to make supply chains more resilient in the future. Regulators can also benefit of the relationships business have built with host governments, often a crucial element for effective due diligence.

No fixed schedule has yet been published however the consultation exercise is expected to start in the coming weeks. No set date has been given but the Brussels rumour mill suggests this is likely to be early September at the latest. It will last approximately three months and everyone is invited to take part. Feedback from this process will then inform a legislative programme that will start in early 2021 with the publication from the European Commission on draft legislation that will then go through a series of reviews and amendments. Finalised legislation is then expected to be approved by the end of the year. It is important to follow how

these progresses to fully understand how it could impact your business.

Outlook

Raising due diligence standards in extended global supply chains is a key business, social and governance responsibility. It is commendable that the EU is taking a lead on this. However, in addition to legislation, a principle-based approach that encourages public-private partnerships and multi-stakeholder approaches to addressing supply chain gaps is as critical to ensure that supply chain due diligence is effective. Other complementary building blocks that have proved successful include sectoral taskforces, bringing together governments and private organisations, geo-tagging of upstream sectors, local stakeholder involvement, engagement in traceability efforts, regular third-party audits and whistle-blowing programmes. Whatever approach is taken, it will require companies and policymakers to work together. A theoretical framework will not work unless it understands, appreciates and seeks to accommodate operational realities. After all the UN Guiding Principles rely on business to instigate changes in the countries of operation. This is unlikely to work if legislation discourages investments in these countries. Establishing the principle of due diligence is important, however changing things on the ground is the imperative.

ADDENDUM – SECTOR INSIGHTS

How could new legislation impact different sectors?

Some sectors are more globalised than others. Some are more complex in their production processes. We look at three specific sectors to provide an overview as to the potential impact this could have:

Labour standards in global fashion and garments industry

The global fashion and garments industry has one of the most complex globally integrated supply chains and this has made the industry particularly vulnerable to COVID-19, due to the different pace of lockdowns across the world and its impact on production.

More than 70 percent of European and US consumers expect to cut back spending on apparel (source: McKinsey - State of Fashion report 2020) which will impact the economy of vulnerable producing countries such as Bangladesh, Sri Lanka, India, Myanmar and Vietnam, whose workers have been already severely hit by the crisis. Historically, salaries and work conditions have been causes for concern and

have been remedied with stringent audits and checks by global brands. Despite this, inadequate sub-contractors' oversight continues to be an area of risk. In the current COVID situation, many global brands have been engaging locally with government agencies and the International Labour Organisation (ILO) to build industry resilience and set up temporary social protection schemes for workers affected by closure of textile and garment-making operations across Asia. The current public health crisis brings alive the reality that not all labour in these textile and garment making factories are 'formalized' and have adequate union-backed policies to protect them during this time. In these times of crisis where millions of workers depend on the garment industry for their livelihood the social role of the industry has been only reinforced but lots of questions are now on the table including how to make the sector more resilient in the face of a global recession and falling market demand.

Socially aware millennials are unlikely to forgive fashion brands that shirk from their social obligations to their workers, no matter in which jurisdiction they operate. Apparent quick financial fixes in the garment factories in Asia could face a backlash in home markets that brands can barely afford during recessions. In Bangladesh alone, 4.1 million people work in the garment-making industry. Global companies will have to be careful not to pull the plug on operations that could render significant proportion of the population unemployed. In many ways, they may have to reinvest to ensure that workers engaged by their suppliers stay supported. Global brands will have to ensure that their suppliers and contractors track and report worker welfare initiatives to a higher degree than before or face the prospect of losing business.

Paying more attention to brands' purpose may also drive the brands to invest more and pay stricter attention on due diligence and increase the social role of businesses without the intervention of the regulator.

Key Question: Will the EU use its regulatory and financial power to force greater oversight over the production and consumption in the fashion and garments sector? The EU may put down more stringent requirements for social audits and insist on metric-based recovery instruments, penalizing for missed or lacking social and environmental standards in the global supply chain.

Use of critical metals and minerals in the chemicals, automotive and tech industries

Global companies in the Chemicals, Automotive and Tech industries source components from around the world, with many modern appliances manufactured in Asian factories. A lot of these factories use intermediate products and components that may have used metals or minerals sourced from conflict zones or regions with weak regulatory oversight. According to the UN's International Labour Organisation (ILO), more than a million children around the world are engaged in child labour in mines and quarries, many of them in artisanal and small mining (ASM). In December 2019, Washington DC based human rights firm [International Rights Advocates](#) filed a lawsuit against leading global tech majors, acting on behalf of 14 parents and children from the Democratic Republic of Congo (DRC). The children worked in the cobalt mines, from where global companies had indirectly sourced cobalt as input for electronic products from mobile phones, to computers and electric vehicles. This has been a wake-up call for global majors.

Once the EU apportions responsibility for due diligence on global companies based or operating in Europe, global brands will have to quickly ensure that all components can be traced easily to their points of origin and certified to be 'fair' and sustainably sourced. This is the Extended Producer Responsibility (EPR) framework applied backwards into the supply chain. There have been some good voluntary industry initiatives such as the Extractive Industries Transparency Initiative (EITI), OECD Due Diligence Guidance for Responsible Supply Chains of Minerals and the Responsible Mica Initiative (DISCLAIMER: RMI is an FTI client), but EU mandated supply chain due diligence would add significant compliance costs to global majors. Tech-assisted traceability solutions that leverage geo-tagging of mines, tracking transport and processed volumes from factories is relatively easy today. Government agencies in many jurisdictions have created disclosure obligations with mine lease agreements. Unfortunately, this is not applied for every metal or mineral, or even across all mining jurisdictions, opening the door for abuse and exploitation.

Creating robust traceability infrastructure to track metals and minerals shipments from mines to beneficiation plants, to processing plants and through custom gates to international borders requires an eco-system and multi-stakeholder approach. The challenge lies in the upstream

– where the labour may be informal and/or unorganized, especially in smaller operations, to be recognized in many parts of the world.


Key Question: It will be challenging for the EU to mandate due diligence in the metals and mining sector where the mining jurisdictions lack necessary traceability infrastructure. Will public-private partnerships emerge to fill this gap? Or will companies have to invest to build these capabilities on their own?

Labour and environmental standards in the global food industry

Fair trade practices in global agri-businesses is now well established, yet as companies expand their base of suppliers to cover new geographies and jurisdictions, it is seldom a smooth transition. The challenge comes from new regions and suppliers who need to be introduced to the stringent labour and environmental sourcing standards of some of the global majors. The reality is 60% of the world’s child labour is in the agriculture sector (ILO).

Global food companies have strong ‘ethical sourcing’ organisations within their enterprises. However, if the same stringent traceability philosophy was applied for the food sector as attempted for metals and minerals, new capacity and infrastructure would have to be created - for every agricultural produce and every step in the supply chain from the farm onwards.

Key Question: Non-tariff barriers on agricultural produce are frequent, as governments tend to protect politically sensitive farm constituencies. It will be important to ensure that EU due diligence requirements on food products don’t take the form of protectionism and mounting barriers for global trade and suppliers from developing countries.



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