

A photograph of a garment factory. In the background, several workers in white lab coats are working at sewing machines. In the foreground, a young girl with dark hair, wearing a white lab coat, is focused on operating a sewing machine. The room has large windows on the right side, letting in bright light. The overall atmosphere is one of a busy industrial environment.

BRIEFING NOTE

# NO FIRM IS AN ISLAND:

## THE IMPORTANCE OF SUPPLY CHAIN DUE DILIGENCE

NOVEMBER 2020

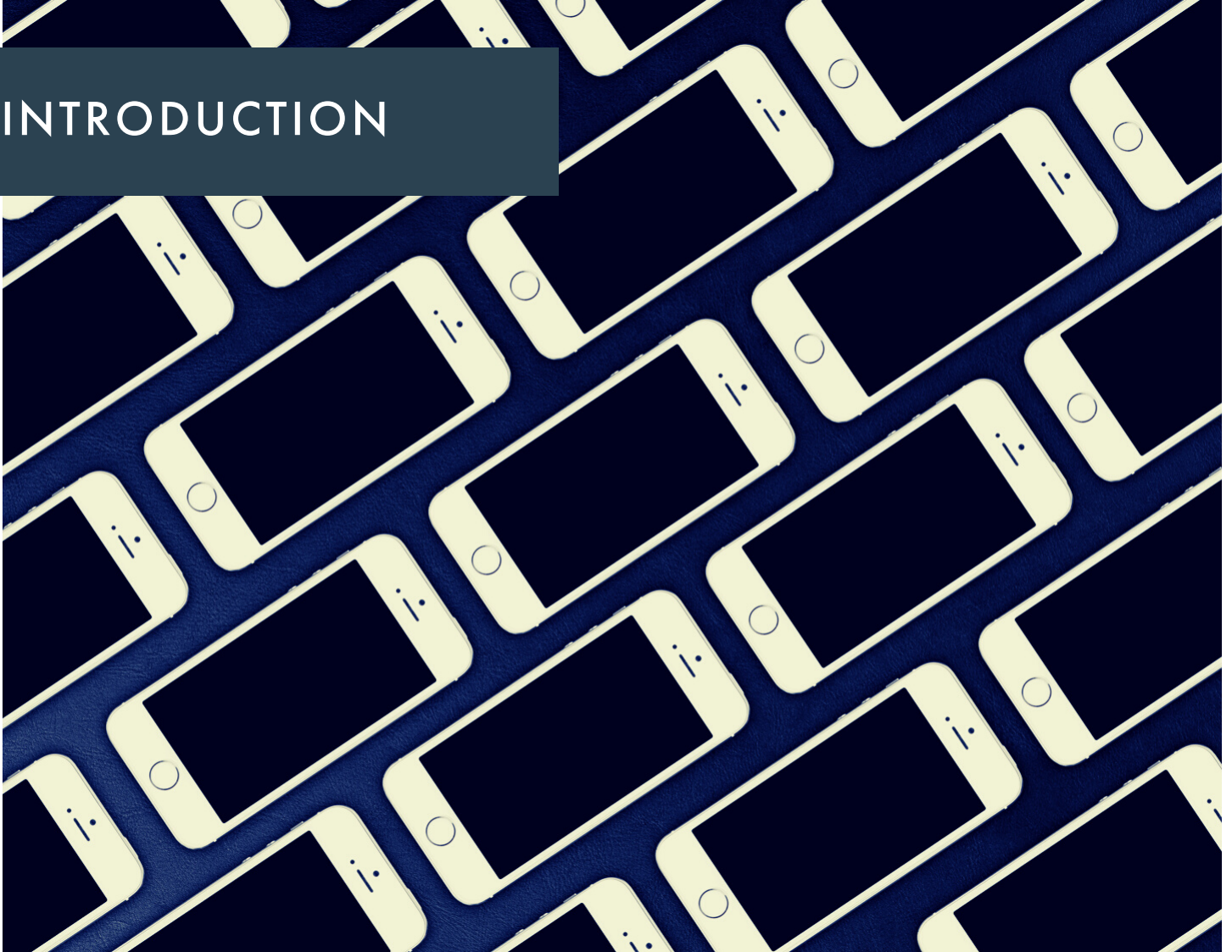
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# INTRODUCTION



In March this year, the Australian Strategic Policy Institute (ASPI) reported evidence of forced Uighur Muslim labour in four separate Chinese factories, spanning the supply chains of Apple, Nike, BMW and Amazon. ASPI estimated that circa 80,000 Uighurs were forcibly displaced to factories across China between 2017 and 2019, as part of a coordinated government campaign of Sinicization and persecution. This campaign has purportedly also included the imprisonment of over one million people in detention camps, as well as compulsory sterilisation and state-funded mass rape, and has prompted the UK to impose its first Chinese human rights sanctions.

Of greatest concern is the sprawling Foxconn factory complex in Zhengzhou known as “iPhone City”, which produces over half of the world’s iPhones and counts at least 350,000 workers – and which was found to utilise forced Uighur labour. The ASPI report estimates that over 2,700 Uighurs have been placed in Apple’s supply chain alone since 2017. Given the high and continuously growing popularity of iPhones and other Apple products across the globe, this puts many in the position of unconscious end consumer of conflict-tainted products, unwittingly complicit in the economic support of ethnocide.

In a fully globalised society where work is progressively outsourced to cheap or specialist third parties in far-flung corners of the globe and where an increasing importance is placed on ESG issues, such reports highlight just how paramount a thorough and comprehensive understanding of all supply chain components is for organisations – for the purposes of regulatory compliance and reputational management as well as for ethical peace of mind.

# WHAT IS SUPPLY CHAIN DUE DILIGENCE (SCDD) AND WHY IS IT NECESSARY?



In 2018, the trade publication IndustryWeek ran an interesting thought experiment related to Iranian sanctions which highlighted the sheer number of companies involved in the shipment of just one 40-foot container. Even the most pared down, conservative estimate included ten entities - seller, insurer, origin warehouse, origin trucker, ocean carrier, destination trucker, destination warehouse, freight forwarder and buyer – without accounting for the additional “touch” of privately owned ports, rail carriers, trucking subcontractors, ship charterers and brokers.

This well-wrought example illustrates the level of risk inherent in many quotidian 21st century transactions which implicate complex supply chains. The competitive advantage conferred by cheap or specialist outsourcing of services is a double-edged sword. As companies open their supply chains up to international contractors who operate according to different social values, regulations and governance, as well as different economic pressures or drivers, Western consumers judge them – and the companies that use them – by their own geographically and culturally informed ethical standards.

Supply chain due diligence involves research and investigation into the constituent parts of a company’s supply chain to ensure its integrity and adherence to organisational, stakeholder and regulatory standards. It encompasses onboarding questionnaires and formal due diligence for high risk jurisdictions or industries prior to engagement with relevant third parties, as well as ongoing monitoring of existing relationships. SCDD does not end when the ink dries on a third party contract; suppliers’ risk profiles evolve over time as they amend their policies, processes and own supply chains, and regular review and assessment are integral parts of an effective SCDD process.

Since ongoing monitoring of existing relationships is essential for the rapid identification of emergent risks, due diligence processes themselves should not remain static over time. As organisations develop, expand or diversify and the cultural and social landscape around them shifts, the risks they face will also transmute and their due diligence focal areas and mechanisms will need to change and accommodate accordingly.

Supplier relationships should also be subject to clauses and requirements to monitor their own chains and ensure these abide by regulations. Yet organisations are ultimately responsible for ensuring the full length, depth and breadth of their supply chain is really scrutinised. It is easy to consider the penetration of a couple of levels adequate, but to do so negates the object and spirit of the exercise. With each new layer of sub-contraction, profit margins tighten and the incentive and scope for fraud or corruption increase. With many physical electronic components and materials originating in Chinese and Indian factories, cases like Apple’s should act as cautionary examples.

# INTERNATIONAL REGULATION AND GUIDANCE



As the primary tool guiding companies' approach to determining whether their partners are acting ethically and legally, SCDD regulation is presided over by different bodies. The UN Guiding Principles for Business and Human Rights and the International Labour Organization's Tripartite Declaration of Principles Concerning Multinational Enterprises both demarcate organisations' responsibilities for ensuring their activities do not support or fund human rights violations - and recommend risk-based SCDD for this purpose.

The Organisation for Economic Co-operation and Development (OECD) has published a series of due diligence-related guidance documents, including Guidelines for Multinational Enterprises, a Risk Awareness Tool for Multinational Enterprises in Weak Governance Zones, Due Diligence Guidance for Responsible Business Conduct, and specific Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. These documents provide practical assistance and tools to help companies undertake SCDD and translate legal responsibilities into actions. Although sector-specific, the OECD guidance related to mineral supply chains is considered something of an international benchmark for SCDD. It was developed in tandem with the private sector, NGOs and governments, and recommends third party audits for companies' due diligence processes, supply chain risk assessments rooted in checks conducted on the ground and public reporting on findings.

In 2018, the Office of Foreign Assets Control (OFAC) published its Risks for Businesses with Supply Chain Links to North Korea - a specific piece of guidance related to the country's government, which forcibly exports its citizens abroad to fulfil labour contracts and generate hundreds of millions of dollars annually to support its weapons of mass destruction and ballistic missile programmes.

In June 2020, the Financial Action Task Force (FATF) echoed OFAC, urging countries and companies to undertake enhanced due diligence in relation to North Korea and Iran to counter ongoing money laundering, terrorist financing, and proliferation financing risks emanating from both jurisdictions. Secondary US sanctions on North Korea and Iran now designate non-US firms dealing with these jurisdictions - in a supply chain as well as a trading sense, or simply in a US dollar currency - as subject to US sanctions themselves, through the Countering America's Adversaries Through Sanctions Act and the Korean Interdiction and Modernization of Sanctions Act.

# NORTH KOREAN RISKS



MADE IN  
CHINA

In order to circumvent the trade sanctions imposed to curtail its nuclear development programme, North Korea has engaged in increasingly evasive tactics. For instance, earlier this year, the UN Panel of Experts on North Korea noted that the use of ship-to-ship transfers – i.e. the movement of commodities between North Korean and non-sanctioned vessels in international waters – has “increased in scope, scale and sophistication”. These transfers are used both to import fossil fuels and export products to the global market. They are aided by fraudulent labels of origin (e.g. “Made in China”) which creates difficulties for companies trying to identify North Korean influence in their supply chains.

Given its own comparative economic and international diplomatic isolation, North Korea is heavily reliant on China for trade. The countries’ shared border allows for easy labour exportation (China purportedly hosts high volumes of North Korean labourers in its factories), as well as extensive use of ship-to-ship transfers in the intervening Yellow Sea. China increasingly subcontracts work to North Korean factories and Chinese-North Korean joint ventures are rife across a range of industries – causing OFAC to label China a high-risk jurisdiction when it comes to navigating North Korean sanctions.

Sanctions often force countries to forge new trading links with each other. Iran, for example, has recently supplied Venezuela with natural gas concentrates that it would previously have imported from the US. With China and Russia both bordering North Korea, and all currently subject to sanctions of some kind (most broadly in the US), it is likely that these countries will work more and more closely and creatively to evade economic restrictions and permeate global markets. As such, standard and desk-based due diligence may not always be sufficient to identify a nexus between these high-risk jurisdictions. It is therefore crucial that companies undertake specialist due diligence where required.

Indeed, companies that fail to recognise or prevent the infiltration of sanctioned North Korean products into their supply chains can be issued hefty fines. One of the most infamous and widely-dissected such cases implicates the US company e.l.f. Cosmetics (ELF), fined just shy of \$1m USD by OFAC in 2019 for unknowingly importing 156 shipments of North Korean-derived false eyelash kits from China.

Although it was just a sliver of what the potential penalty could have been (and less than half of its original value), ELF’s fine is notable for the fact that the company voluntarily self-disclosed the violations, cooperated fully with OFAC’s investigations and proved that none of its staff were complicit - yet was still penalised for SCDD failures. OFAC deemed its sanctions compliance programme “inadequate to non-existent”, citing a lack of supply chain audits to verify ultimate country of origin, supplier compliance certifications, enhanced supplier audits and staff training.

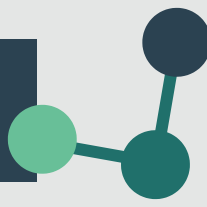
# REPUTATIONAL RISKS



Admonitory tales abound when it comes to inadequate SCDD and subsequent reputational damage suffered by companies. Earlier this year, Boohoo faced severe media criticism, a plummeting share price and AIM devaluation (by circa £1bn), and was subject to an investigation by the National Crime Agency following evidence of poor labour practices and exploitation in a Leicester garment factory in its supply chain.

Subsequent investigation revealed that Boohoo's purported supplier, Jaswal Fashions, had ceased trading two years previously. An entirely separate and unidentifiable company was leasing and operating on Jaswal's former factory premises. Although it is unclear to what extent Boohoo was aware of this (the company has declined to comment on whether this 'second supplier' was on its supplier list), the case clearly demonstrates the importance of actively monitoring existing partners rather than simply evaluating potential new third party relationships, as well as the extent to which a situation can combust when this practice is neglected.

# CONCLUSION



Last month, HM Revenue & Customs issued a timely update to its Advice on Applying SCDD Principles to Assure Your Labour Supply Chains, citing tax evasions, modern slavery, human trafficking and exploitation as particularly relevant risks. It specifically noted the importance of rigorous assessment of suppliers' workforce to understand what the relationship between labourers and supplier is, who the workers are, who is responsible for their pay (and how much this is), what their employment status is and – tellingly, given the Boohoo case – an assurance that the supplier 'actually exists', for example, through examination of their commercial features and details of onward subcontracting.

However, rather than framing SCDD as a regulatory necessity or box-ticking exercise, organisations should recognise it as an opportunity. By taking a proactive approach and not only undertaking SCDD but also publicly reporting on related risks and mitigating actions, companies can demonstrate their commitment to responsible and sustainable sourcing to stakeholders and thus make themselves more attractive as a business prospect.

By exercising their own consumer power, companies can also enact a change in supplier attitudes, whereby adherence to ethical standards becomes the 'smartest' and most rewarding means of conducting business. Global Witness, for example, claims that thoroughly conducted SCDD has the potential to tackle the trade of conflict minerals far more efficiently and effectively than other options like mineral certification.

When it comes to supply chain risks, ignorance is no excuse and non-compliance is rarely rewarded. Themis can support your wide-ranging SCDD needs: our skilled team of investigators has deep and varied experience across a range of sectors and is well-equipped to handle all your due diligence queries, requirements and concerns.

We use our experience investigating ESG concerns to identify companies' greatest areas of risk based on both ESG benchmarks and the United Nations Sustainable Development Goals. We help to map out firms' subsidiaries and supply chains, identifying areas of specific risk and investigating areas of concern in more detail.

Besides working with you to understand and assess existing supplier relationships, we can help bolster your internal due diligence procedures, and tailor red flag indicators to ensure that your processes are targeted and effective. With ESG issues rising up stakeholder agendas, scrutiny of organisations' supply chains will only intensify and companies will certainly reap the future benefits of any resources invested now.



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