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The Other "S" in ESG: Building a Sustainable and Resilient Supply Chain

The current pandemic, blind spots in information flows through supply lines, the shutdowns in meat processing plants around the world, the ongoing shortages in personal protective equipment and, most recently, the scandal involving British retailer Boohoo, have all underscored the importance of resilient, sustainable, legally compliant and ethical supply chains. In addition to geographic and industry-specific challenges, issues relating to health and safety, labor practices and climate risk have become top priorities for investors, regulators and consumers. Failure to ensure proper oversight and management of supply chains can result in significant reputational and economic losses, as well as regulatory scrutiny. Companies that invest in this area also benefit from competitive advantages, faster recovery from disruptions and, for those who wish to demonstrate leadership, broader impact. For many companies, the pandemic has provided new insights into their supply networks, revealed an unsettling lack of full visibility into their supply chains, and exposed weaknesses and gaps between first-tier and lower-tier suppliers. Set forth below are some considerations for boards and management teams looking to integrate supply chain considerations into their oversight of ESG matters and to understand how their companies can build back stronger and better in the aftermath of the pandemic:

Focus on Transparency. The complexity of modern-day supply chains means that a variety of ESG risks can be embedded in a company's business without management's knowledge. Identifying operational weaknesses among second- and third-tier suppliers is a challenge not only for companies that have offshored, but also for companies that have or are reliant on third-party software providers that have access to sensitive consumer and competitive data. Companies are increasingly called upon to disclose their supply chain practices as part of ESG disclosures (the Sustainability Accounting Standards Board (SASB), the consultation draft of an ESG reporting framework proposed by the World Economic Forum and the Global Reporting Initiative (GRI) contemplate supply chain-related disclosures) or in connection with a growing number of shareholder proposals, and as ESG ratings agencies seek to measure and assess supply chain risks, companies should implement processes that track all elements of their supply chain. Companies should determine which standards and practices they expect suppliers to meet and whether and how to apply these expectations to first-tier versus lower-tier suppliers. These processes should seek to ensure alignment between company and supplier practices, policies and training, as well as efficient channels for reporting and addressing compliance issues and unethical practices, particularly as they relate to human rights, labor conditions, and misuse of data and corruption.

Consider Climate Change Risks and Opportunities. The reduction of carbon footprints, including where supply chains occupy a significant portion of that footprint, has become a key issue for many companies. For example, Apple announced recently that it intends to create a carbon neutral supply chain by 2030, and a number of other companies have made commitments to reduce the carbon footprint of their operations. Looking ahead, it will become increasingly important for companies to engage and collaborate with their suppliers to identify avenues for leveraging renewable energy, reducing waste and streamlining manufacturing and logistics.

Additional engagement and collaboration will also be needed to fully assess and manage potential climate change-related risks and opportunities. Shifting climate patterns already pose a threat to infrastructure and introduce new uncertainties to traditional supply chains. Maintaining a robust and sustainable supply chain will require companies to integrate supply chain management into long-term climate risk management plans.

Scrutinize Compliance. Compliance remains a key challenge for companies with heavily outsourced global supply chains that have historically faced issues relating to human rights, fair labor practices and anti-corruption laws. The digitization of the global economy has exposed a growing number of companies to data compliance issues as new laws and regulations on data privacy and cybersecurity are implemented. In addition, the ongoing shift toward stakeholder capitalism and renewed focus on corporate purpose and culture means that investors and consumers will be less forgiving of misconduct by third-party suppliers (or, as Boohoo demonstrates, sub-suppliers). The operational challenge for companies is to align supplier monitoring and compliance practices with those of the company. Such efforts may require additional investment in training, screening, monitoring and reporting, and possibly a reconfiguration of high-risk supply chains.

Consider Regulatory Risk. While companies operating in strategically sensitive sectors such as telecommunications, biotechnology, infrastructure and energy have long been subject to regulatory scrutiny, the rise of the data economy, growing U.S.-China tensions and, most recently, the pandemic, have brought into focus the need for greater regulatory scrutiny of supply chains, both physical and virtual. Political rhetoric and proposals to encourage reshoring have intensified in the past few months: two bipartisan bills introduced in June both aimed at providing government funding for domestic semi-conductor-related research and development, and President Trump recently signed an executive order directing federal agencies to prioritize purchasing certain drugs and medical materials made in the United States. And the Committee on Foreign Investment in the United States (CFIUS) recently expanded its jurisdiction to include sectors involving sensitive personal data. As long as bipartisan political momentum for reshoring remains, companies should carefully consider whether their industry may be affected and how they can reconfigure their supply chains to adapt to new policymaking.

M&A Diligence. Understanding supply chain risks should also be a key priority during M&A due diligence. In certain industries where there are multiple tiers of supply chains, it is important for acquirers to obtain access to and knowledge of current and past vendors, as well as an understanding of risk management and reporting processes. Depending on the circumstances and the potential synergies arising from supply chain integration, it may be necessary for acquirers to conduct independent inspection and verification of the supply chain. M&A diligence should also cover the policies and procedures in place to ensure ethical conduct throughout the target's supply chain.

Balance Efficiency and Resilience. One of the biggest lessons learned from the pandemic is how the focus on supply chain efficiency has come at the cost of resilience. Efficiency can become an operational risk, as demonstrated by the aggressive offshoring of production of personal protective equipment. Efficiency can also make supply chains more fragile as demonstrated by the outsized impact of delays in China on companies across multiple industries.

A sustainable supply chain is one that is able to anticipate and adapt to unforeseen events. For companies that have stumbled during the pandemic as a result of supply chain miscues, it will be especially important to identify the right balance between efficiency and resilience, bearing in mind that efficiency risks need to be addressed at all tiers of the supply chain.

Consider Emerging Technologies. An increasing number of companies, in addition to the U.S. government and military, are testing and exploring the use of distributed ledger technologies, including blockchain-related tools, in the supply chain context. In addition to potential cost and efficiency benefits, the technology offers the possibility of accelerated decision-making, improved tracking and tracing (including for customers and partners), reduced cross-organizational friction, rapid information sharing across supplier tiers and enhanced enforcement of intellectual property rights, verification of authenticity and compliance benchmarking. Emerging technologies can be expected to play an increasing role in modern, resilient and sustainable supply chains.

Anticipate Emerging Areas of Focus. As investors broaden their focus to areas of biodiversity, waste and water use, companies are also addressing these issues in their sustainability commitments, risk management assessments and supply chain construction, and some companies have already made announcements and changes relating to these areas. A range of private sector and public sector working groups and initiatives are also underway that would formally focus on ecosystem and nature-related disclosures and assessments (*e.g.*, the Task Force on Nature-related Financial Disclosures that is backed by several global financial institutions, the UK and Swiss governments and the World Business Council for Sustainable Development). Forward-looking companies assessing their supply networks will want to consider how supply chain designs and impacts factor into these areas.

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As supply chain issues continue to draw the scrutiny of investors, regulators and consumers, and implicate a range of ESG issues, it will become increasingly important for boards to familiarize themselves with how their companies are managing their supply chains across first-tier and lower-tier participants, including overseeing how supply chain considerations are integrated into operational, strategic and risk management processes.

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