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Due Diligence Obligations in Metal Supply Chains

Traders and exchanges are key sustainability actors

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The German government intends to establish standards for responsible sourcing of metals, and laid out its objectives in a position paper in January 2023 ("Paths to sustainable and resilient raw material supplies"). German firms source much of the metals they use through traders, exchanges and over-the-counter markets. These tend to be located outside the European Union in countries whose regulations on corporate due diligence are weaker than the EU's. Given the central role of commodity traders and exchanges in securing the supply of metals and enforcing sustainability standards in metal supply chains, the German government should ensure that its implementation of its position paper devotes commensurate attention to the commodity trade. Robust supply chain legislation at the EU level, also covering the financial sector, will permit Germany to exert indirect influence on commodity traders, exchanges and over-the-counter markets.

Access to metals is absolutely crucial for European and German industry — especially given the growing competition over metals for the green and digital transformations. Commodity traders, metal exchanges and over-the-counter markets play a crucial role as mediators in complex metal supply chains. Traders purchase, blend and sell ores, concentrates and secondary material from diverse sources and in some cases operate their own mines and refineries. In other words, they operate in multiple, geographically dispersed stages along metal supply chains and connect the different actors along them. Producers, processors and buyers trade physical metal and derivatives at metal exchanges and over-the-counter markets. Derivatives are of great importance for risk hedging and price determination.

As connecting elements, commodity traders, exchanges and over-the-counter markets possess great potential influence over standard-setting in metal supply chains, by demanding that metal producers rigorously observe sustainability standards and by implementing human rights and environmental due diligence in their own supply chain. They can also pass on information about provenance, production conditions and supply chain risks to their buyers. That is vital for major German businesses sourcing metals through traders and exchanges. Since the German Act on Corporate Due Diligence Obligations came into effect in 2023 they are required to ensure that their immediate suppliers observe human rights and certain environmental standards.

Global trading hubs

The global metal trade is organised by actors based outside the EU. Switzerland and the United Kingdom (specifically London) are the most important centres for Europe. Switzerland is home to numerous transnational physical commodity traders, largely conducting transit trade. What that means is that the Swiss companies organise the physical trade between third states, but the goods never enter Switzerland and therefore do not appear in the country's official customs statistics. In 2021 eight of Switzerland's ten largest firms by turnover were commodity traders, including Glencore and Trafigura as major traders in physical metals. The Swiss government estimates that Switzerland accounts for 60 per cent of the global trade in metals. Singapore and Shanghai together have a market share of 20 per cent; London supplies 10 per cent. So the EU's metals are imported principally through actors in Switzerland and the UK.

London is home to the major exchanges and significant over-the-counter trade. The London Metal Exchange (LME) is the world's most important trading venue for industrial metals, while the London Bullion Market (LBMA) and the London Platinum and Palladium Market (LPPM) are major over-the-counter venues for gold, silver, platinum and palladium. Other globally important metal exchanges include the Chicago Board of Trade, the New York Mercantile Exchange and the Shanghai Futures Exchange.

Traders and exchanges connect producers and purchasers, and serve crucial functions in metal supply chains.

Commodity traders: influential all-rounders

Commodity traders play an important role in metal supply chains by sustaining the movement of physical product across national borders. They also assume specific risks, including exchange rate and pricing risks. Physical commodity traders generally hedge such risks using derivatives, which are traded on exchanges. Their business tends to be capital-intensive and funded through credit, performance bonds and letters of credit. In the latter case the importer's bank guarantees that the exporter will be paid.

As well as *purchase and sale of physical metal*, the larger commodity traders also offer a string of services for producers and purchasers: *administrative activities* like inspection, quality control and execution of payments; *logistics*, in particular transport from mine or refinery to port or airport; and also shipping and distribution. In order to operate independently of logistics firms and generate additional income, major commodity traders own loading terminals and sometimes even their own shipping fleets, or take stakes in local forwarders and fuel suppliers.

Warehousing is another core activity for traders. Stocks of saleable metals are aggregated and ores and concentrates of different provenance and purity blended for sale to refineries. This makes it almost impossible to trace ores back to their source.

Another essential function of commodity traders is *funding* mining ventures, for example using direct credit or prefinancing loans to secure long-term access to resources.

The major commodity traders have successively expanded their activities to include *mining itself and processing* in smelters and refineries. Glencore for example operates copper mines, smelters and refineries in the Democratic Republic of the Congo, Australia and South America. That kind of vertical integration puts traders in an excellent position to bring transparency to material flows and risks in metal supply chains and to enforce standards along them.

Exchanges set prices and standards

Metal exchanges trade principally in securities and derivatives rather than physical metal. While the LME does offer the possibility of physical trade and has licensed warehouses across the globe, in reality less than 1 per cent of its contracts are fulfilled by physical delivery to any of its warehouses. On the other hand trade in platinum and palladium through the LPPM is largely physical.

Metal exchanges and over-the-counter markets function as *marketplaces bringing together sellers and buyers*. They are used by metal producers (miners, smelters, refineries), industrial consumers and commodity traders. They are also used by banks, investment funds and institutional investors to *hedge risks* and in some cases to speculate.

Metal exchanges also serve an important *price-determining* function. The LME's daily price listings are the internationally recognised benchmark. Contracts concluded directly between commodity traders and purchasers tend to orientate on the LME's pricing (or LBMA for gold and silver, LPPM for platinum and palladium).

Another central function of metal exchanges and over-the-counter markets is *regulation and standard-setting*. Exchanges define minimum standards for traded metals, for example quality and purity. For some years now, metal exchanges and over-the-counter markets have also been establishing requirements concerning responsible procurement and transparency of provenance, in response to growing public pressure. For example in 2017 the NGO Global Witness informed the LME that cobalt traded by a registered Chinese company was being produced using child labour in the Democratic Republic of the Congo. In response LME changed its rules to permit brands to be delisted on grounds of unethical business practices.

Risky supply chains

The example of the LME underlines how companies involved in commodity trading find themselves confronted with supply chain risks. Not only are there significant human rights and environmental risks in the upstream supply chain of exchanges and commodity traders. The latter are also exposed to specific risks associated with trading.

High risks in mining, processing and transport

A survey of Swiss commodity traders in 2017 identified "labour standards; environmental protection; occupational health and safety; community health and safety; rights of Indigenous Peoples; use of security forces; issues relating to local community resettlement" as the biggest risk factors in the upstream supply chain. But (violent) conflicts in mining regions, for example over land use, also present risks. The potential negative environmental consequences of mining and refining include air pollution, acidic mine drainage, contamination of ground and water with heavy metals, failure to rehabilitate abandoned mines, and the sector's generally large carbon footprint. There are also — to date less prominently discussed — human rights and environmental risks in connection with transport and storage, such as forced labour and debt bondage in the shipping sector.

Although metal exchanges and over-the-counter markets are not themselves involved in the physical trade, they are nonetheless exposed to risk if accredited producers violate human rights and environmental standards, because that undermines confidence in the effectiveness of their regulatory systems.

Specific trading risks

Other risks fall directly in the responsibility of commodity traders. One such is the issue of funding of armed conflicts, repressive regimes and terrorism through trade in illicit metals or through business relationships with prominent politicians or criminal individuals. For example *Al Jazeera* revealed in March 2023 that senior members of the Zimbabwean government were involved in a scheme to evade sanctions by smuggling billions of dollars' worth of gold to Dubai every month. Efforts to address metal smuggling from repressive states and conflict regions often focus on formalising artisanal mining but fail to pursue systematic action against criminal networks at the international level.

Precious metals like gold and platinum are most susceptible to criminal activities on account of their high value-to-weight ratio. Lax customs and import controls have made the United Arab Emirates a hub for the illicit trade in gold from Africa. After processing in refineries in the Emirates, it passes on to Switzerland, India and China — and thus indirectly to the EU market.

Action has already been taken to regulate the trade in conflict minerals — tantalum, tin, tungsten and gold (3TG) mined in conflict-affected and high risk areas (CAHRAS). — and reduce the revenues accruing to warring parties. In 2010 the United States adopted the Dodd-Frank Act, which requires US-listed companies to disclose any use of conflict minerals from the Democratic Republic of the Congo or neighbouring states. They must also provide assurances that the mining of 3TG minerals used in their products does not fund armed conflict. The EU's Conflict Minerals Regulation of 2017 also places binding due diligence and auditing obligations on EU companies importing 3TG minerals from particular CAHRAS. Although the Swiss and British commodity traders who provide much of the EU's supply of 3TG minerals are not directly affected by the regulation, they do treat the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas as the established sectoral standard. Its drawback is that it is not binding.

Conflict minerals apart, trade in metals in general is much more loosely regulated — although risks naturally exist there too. Dealings with actors involved in the illegal trade in metals bring physical commodity traders into (indirect) contact with money laundering, corruption and tax evasion. Sometimes commodity traders are even directly implicated in criminal activities. A report by the Anti-Corruption Resource Centre in 2017 documents a string of cases where traders bribed politicians in producer countries in order to gain access to cheap minerals.

The great complexity of metal supply chains and the difficulties tracing provenance pose challenges for comprehensive due diligence. The trading sector has begun devoting greater attention to the issue of sustainability, but still lags a good way behind other metal supply chain actors.

Room for improvement in due diligence

Commodity traders, metal exchanges and over-the-counter markets, as important links in metal supply chains, play a decisive role in implementing and enforcing sustainability standards. But for various reasons they are not yet making the most of their possibilities in the area of standard-setting.

Weak regulation in trading centres

The biggest deficit is weakness of regulation in metal trading centres. Switzerland and the UK are particularly relevant for the EU market. Switzerland is a member of the OECD and the Extractive Industries Transparency Initiative (EITI), which is an international initiative of states, corporations and NGOs working for good governance and transparency in the commodity sector. Switzerland has also published guidance on implementing the UN Guiding Principles on Business and Human Rights in the commodity trading sector. The Swiss Code of Obligations was amended in January 2021, to require resource-extracting enterprises to disclose all (aggregate) payments of 100,000

Swiss francs (approx. €102,000) or more made to government authorities. But overall the legal obligations placed on businesses remain weak. The referendum for the Responsible Business Initiative, which proposed a Swiss equivalent of the German supply chain legislation, failed at the end of 2020. The UK also lacks such legislation, although the LME does fall under the 2015 Modern Slavery Act which requires businesses whose turnover exceeds £36 million to report steps taken to ensure that slavery and human trafficking are not occurring in their supply chains.

Slow implementation of voluntary standards

Given the weakness of statutory regulation in the main trading centres, sustainability standards in the commodity trade are largely implemented and enforced on a voluntary basis.

The leading commodity traders are increasingly working to anchor environmental, social and governance (ESG) standards in their business practices. This process is driven by rising expectations on the part of their customers and massive pressure from NGOs. However a recent analysis of measures adopted by twenty-five major commodity traders to fulfil their corporate due diligence obligations and disclose relevant information reveals that these traders are not working actively to address risks relating to human rights violations, illicit financial flows and environmental harm in their supply chains. Established systems for implementing due diligence obligations, the report says, are weak and frequently restricted to risk analysis, with little sign of progress.

In London's metal exchanges and over-the-counter markets the implementation of sustainability guidance is already compulsory at the LBMA (since 2012 for gold and 2018 for silver) and the LPPM (since 2020). It requires accredited refineries to be independently audited. Not until 2019 did the LME publish a Policy on Responsible Sourcing of LME-Listed Brands, which is oriented on the OECD's Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. From 2024 all market participants will be required to adhere to this guidance. If they fail to do so they can be excluded from trading. The LMEpassport introduced in 2021 allows producers to provide sustainability data on a voluntary basis. The LME's measures are regarded as an important step forward, but also come in for criticism. It is argued that inadequate attention is paid to environmental risks and that data on complaints and violations is not published.

Lack of transparency hinders traceability

The unwillingness of commodity traders and exchanges to supply basic information about provenance and suppliers is especially problematic. This makes traceability more or less impossible. For example the LME publishes no information on the countries of origin of the metals in its warehouses. Commodity traders sometimes provide information on refineries, but rarely on the specific mines from which the metals originate. Precisely that information would be important, because traders often blend ores and concentrates from different mines and conditions can differ widely between mines within a country. There is also a lack of transparency on the externalised costs and environmental impacts of the commodity trade. Information on the number, scope and recipients of prefinancing loans from commodity traders is also not always available.

The traders argue that they need to safeguard commercial confidentiality. The major trading houses are mostly not public companies (with Switzerland's Glencore representing an exception) and therefore not subject to the transparency and ESG rules applied by stock exchanges. Their reticence about providing information on provenance and production conditions poses a risk for German companies sourcing metals through Swiss traders or London's markets.

The decentralised nature of the commodity trade

Ultimately the decentralised nature of the commodity trade stands in the way of systematic implementation of sustainability standards. Alongside a few core trading centres and a limited number of major trading firms, most of Europe's traders are (very) small specialist operations. A survey of the Swiss commodities trading sector in 2017 found that 42 per cent of traders had fewer than ten employees and another 48 per cent had between eleven and three hundred. This large group tends to be neglected when it comes to implementing standards and sharing information.

In the mining countries too, a multitude of actors are involved in trading metals. As well as major international trading companies such as Trafigura, some mining companies run their own trading operations. And then there are numerous smaller local intermediaries, especially where artisanal mining is involved. Often multiple traders are involved between producer and buyer. The power and influence of commodity traders in supply chains varies from metal to metal. This makes it very hard to properly identify the actors involved in the metal trade.

Policy options for Germany

As important trading centres, Switzerland and the UK are crucial to security of supply of metals and enforcement of standards in metal supply chains. Commodity traders and their upstream supply chains are exposed to significant risks and require the implementation of comprehensive corporate due diligence. The regulation and implementation of voluntary sustainability standards remains inadequate in the commodity sector. This creates risks for German and European companies sourcing metals through exchanges and commodity traders. With its Act on Corporate Due Diligence Obligations and the position paper mentioned at the beginning, Germany is seeking to establish strict standards for responsible procurement of metals. To this end the German government should pay close attention to commodity trading, when it considers measures to support implementation of its supply chain legislation and position paper. It should also work at the international level to tighten up regulation of commodity trading.

A strong EU supply chain law

The most important centres for the metal trade lie outwith the EU, which therefore lacks direct influence. Strong European supply chain legislation encompassing the entire financial sector would enable metal buyers within the EU to exert greater pressure on the exchanges and traders that supply their metals. The financial sector plays a significant role in financing the capital-intensive physical commodity trade. So a requirement for financial actors to fulfil human rights and environmental due diligence obligations would also affect commodity trading. The Council of the EU wants to exclude the financial sector from the scope of the EU's directive on corporate sustainability due diligence, while the European Parliament and Commission wish to include it. In order to maximise the impact of European supply chain legislation, the German government should press — both before and during the upcoming trilogue negotiations — for the financial sector to be brought within the scope of the legislation.

Political dialogue on standards

Apart from binding legislation, the German government can expand the political dialogue on standards with important metal trading centres, in particular Switzerland, the UK and China. One obvious framework would be international organisations such as the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) or the G20. While Switzerland is not a member of the G20, it does participate regularly in the group's preparatory meetings. Above all, exchange with China should be maintained despite the geopolitical tensions, for example in the OECD context or through the Sino-German Centre for Sustainable Development, established in 2017 at the initiative of the German Federal Ministry for Economic Cooperation and Development and the Chinese Trade Ministry. By offering greater support for EITI and the UN Global Compact, the German government can also promote transparency in commodity trading and stimulate the political dialogue on implementation of sustainability standards in this area.

Untied loan guarantees

The German government plans to expand the volume of untied loan guarantees (Ungebundene Finanzkredite, UFK-Garantien) granted to commodity traders in order to boost security of supply for metals. In October 2022 Trafigura received a loan of US$800 million to supply up to half a million tonnes of non-ferrous metals to German firms. Given the lack of transparency in the commodity trade and the inadequacy of due diligence fulfilment, the German government is entertaining considerable risks by pledging such guarantees. It could minimise them by expanding the pre-approval review of environmental, social and human rights (ESH) aspects and instituting regular additional ESH audits during the course of the project. Transparency and sustainability should be decisive criteria for granting untied loan guarantees. The standards for ESH audits should be stricter than the Performance Standards of the International Finance Corporation, which represent the established standard in development financing. Guarantees for long-term supply contracts with mining companies would be an alternative to the untied loan guarantees for loans to traders. This would also simplify the ESH auditing, because operators of mines and refineries provide more information on provenance and production conditions.

Multi-stakeholder initiatives

Despite their outstanding significance for implementation of standards, commodity traders (and metal exchanges and over-the-counter markets) are underrepresented in existing multi-stakeholder initiatives. The same also applies to actors from the financial sector. Nevertheless these initiatives can still be an effective instrument for advancing standard-setting and promoting discussion of risks among actors along metal supply chains. The German Federal Labour and Development Cooperation Ministries should therefore work — in national sector dialogues and at European level in the European Partnership for Responsible Minerals (EPRM) — towards greater inclusion of actors from the commodity trading and financial sectors.

Civil society and research

It tends to be NGOs and research institutes that bring to light human rights violations and environmental problems in the supply chains of commodity traders and exchanges. In the absence of public data, they make a substantial contribution to illuminating international trade flows and exposing the risks of the commodity trade. One option for the German government to improve transparency in metal supply chains would therefore be to fund and support relevant NGOs and research projects.

Dr Christina Saulich is an Associate in the project "Transnational Governance of Sustainable Commodity Supply Chains in the Andean Region and Southern Africa", funded by the German Federal Ministry for Economic Cooperation and Development (BMZ).

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