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Legal Liability for ESG Disclosures – Investor Pressure, State of Play and Practical Recommendations


Katherine J. Brennan


Connor Kuratek


Joseph A. Hall


Betty Moy Huber

Marsh & McLennan Companies
Davis Polk & Wardwell LLP

Executive Summary

Corporate Social Responsibility and Environmental, Social & Governance (ESG) issues have become increasingly important over the past few years, and evaluating a company's ESG disclosures has become a key tool used by many investors in making investment and engagement decisions. Many companies are, with increasing frequency, publishing ESG reports on their websites and incorporating ESG disclosure into mandatory filings with the U.S. Securities and Exchange Commission. According to a National Association of Corporate Directors Report, in 2019, 66% of companies in the Russell 3000 Index discussed and incorporated some ESG risk disclosure into their financial filings.[1] The increase in disclosure has been accompanied by an increase in shareholder litigation on ESG issues.

This article is divided into three parts: **Part 1** provides a brief summary of the rise in investor pressure for increased ESG disclosures; **Part 2** describes the SEC response to these trends and disclosure regimes, with a particular focus on the World Economic Forum's 2020 frameworks; and **Part 3** discusses litigation related to ESG voluntary disclosures and what companies can do to limit the risk of associated litigation.

1 Investor Pressure

Companies are facing increased pressure to provide more ESG-related disclosures. Recent letters from influential institutional shareholders such as BlackRock, State Street and the New York Office of the State Comptroller highlight that sustainability will be at the center of investment strategies moving forward.

A. BlackRock

In his January 2020 annual letter to CEOs, BlackRock CEO Larry Fink made clear that he expects companies to change the way they disclose ESG metrics to their investors:

> "We believe that all investors, along with regulators, insurers, and the public, need a clearer picture of how companies are managing sustainability-related questions. This data should extend beyond climate to questions around how each company serves its full set of stakeholders, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data. Each company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders."

Fink went on to warn:

> "Given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."

B. State Street Global Advisors

Also in January 2020, Cyrus Taraporevala, President and CEO of State Street Global Advisors, stated that ESG is "no longer an option for long-term strategy." He went on: "We believe that addressing material ESG issues is good business practice and essential to a company's long-term financial performance – ***a matter of value, not values***."

C. New York State Comptroller

The New York State Comptroller sent letters to companies in 2019 requesting that they "develop robust transition plans and business strategies that are to be aligned with a two-degree and below two-degree future." This refers to the Paris Agreement's long-term goal to keep a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels. As context, current reduction targets (on a national level) are estimated to leave the world on a warming pathway of 3°C by 2100.

These are only a few of the more prominent examples of "private ordering" demand for ESG disclosure, and companies will certainly hear from more institutional shareholders in the future, along with socially responsible investors and single-issue activists.

2 Voluntary Disclosure Regimes and SEC Mandatory Requirements

External pressures such as those described above are likely to make public reporting on environmental metrics inevitable. For companies seeking to make these disclosures, there are a variety of voluntary climate risk disclosure models, many that have been around for decades.

The four most prominent voluntary regimes for U.S. companies are those sponsored by the Global Reporting Initiative (GRI), CDP (formerly known as the Carbon Disclosure Project), Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) and Sustainability Accounting Standards Board (SASB). GRI and CDP have been around the longest and have the highest global market penetration. TCFD and SASB are gaining momentum, both in the United States and abroad.

These initiatives, which are discussed at length in ICLG – Corporate Governance 2019's chapter "***ESG in the US***,"[2] leave companies with a variety of disclosure regimes to choose from.

A. World Economic Forum Initiatives

In January 2020, the International Business Council of the World Economic Forum (WEF), made up of some of the world's largest companies, released in collaboration with the Big Four accounting firms a consultation draft entitled "Towards Common Metrics and Consistent Reporting of Sustainable Value Creation." Organized along four pillars aligned with the UN Sustainable Development Goals (SDGs), **Principles of Governance**, **Planet**, **People** and **Prosperity**, the report proposes a common set of metrics and recommends disclosures to foster consistency in reporting on topics such as greenhouse gas emissions and strategies, diversity and employee health and well-being. These metrics and disclosures are meant to show how a company's ESG performance contributes to the four pillars of the SDGs as described below:

Principles of Governance	Aligned with SDG **12** (Responsible Consumption & Production), **16** (Peace, Justice and Strong Institutions), & **17** (Partnership to achieve the SDGs).	Report calls for disclosure of the company's commitment to ethics and the societal benefits it offers.
Planet	Aligned with SDG **6** (Clean Water & Sanitation), **7** (Affordable & Clean Energy), **12** (Responsible Consumption & Production), **13** (Climate Action), **14** (Life Below Water), & **15** (Life on Land).	Report calls for disclosure of the company's climate sustainability and environmental responsibility matters.
People	Aligned with SDG **1** (No Poverty), **3** (Good Health & Well-Being), **4** (Quality Education), **5** (Gender Equality) & **10** (Reduced Inequalities).	Aligned with SDG **1** (No Poverty), **8** (Decent Work & Economic Growth), **9** (Industry, Innovation & Infrastructure) & **10** (Reduced Inequalities).
Prosperity	Aligned with SDG **1** (No Poverty), **8** (Decent Work & Economic Growth), **9** (Industry, Innovation & Infrastructure) & **10** (Reduced Inequalities).	Report calls for disclosure of the company's business contributions to equitable, innovative growth.

The report states that its goal is to:

> "[R]educe fragmentation and encourage faster progress towards a systemic solution, perhaps to include a generally accepted international accounting standard."

Importantly, the report does not aim to reinvent the wheel, but proposes a set of metrics from pre-existing frameworks, including those discussed above. The report highlights:

> "To the maximum extent practicable, the report incorporates well-established metrics and disclosures for the express purpose of building upon the extensive and rigorous work that has already been done by those who have developed the existing standards. The objective is to amplify those standards and more fully harness their synergies rather than create a new standard altogether."

B. "Dynamic materiality"

In early 2020, the unexpected impact of the COVID-19 pandemic highlighted the challenges companies face in identifying financially material ESG factors in a rapidly changing world. With great speed, the pandemic arguably transformed what were financially immaterial factors into material considerations. To that end, in March 2020, the WEF released a white paper aimed at helping companies identify these factors that are likely to materialize, to safeguard a company's long-term health. The paper examines the concept of "dynamic materiality," and provides a framework to consider how ESG issues that are not material today may become increasingly material in the future. The paper states:

> "Quite practically, this paper offers a framework to better understand how financially immaterial issues become material to business over time and provides a set of questions to guide investors and companies on how to better anticipate emerging issues."

The framework is organized around four main components and provides investors with a lens to better identify and manage dynamic ESG issues, as well as incorporate them into the process of portfolio construction, security selection and stewardship. The components include:

1. Hyper-transparency of corporate practices in the Fourth Industrial Revolution (i.e. artificial intelligence).
2. Escalating stakeholder activism fueled by social media.
3. Changing societal expectations in the new age of stakeholder activism.
4. Growing investor focus on sustainability issues.

Item 1 highlights how evolving technology such as new information generated by AI and blockchain can lay bare corporate behavior and particularly supply chain management integrity. With respect to item 2, the paper focuses on how social media facilitates the spread of otherwise local information to a global audience, thus increasing the speed by which an issue becomes material as well as the transparency of the issue. Regarding item 3, the paper describes how the C-suite must pay attention to consumer purchasing trends, which are increasingly being driven by their values and generally toward creating positive total societal impact. For instance, the paper cites the statistic that 67% of millennials expect employers to have purpose and want their jobs to have societal impact, and gives examples of the sharp rise in employee activism which could result in corporate reputational harm.

C. What's Next?

The mission of the WEF's International Business Council to create a standardized disclosure regime with common metrics and a framework to analyze materiality remains at its early stages. Issued as a consultation draft, the report will not be finalized until later in 2020 after further consultation and feedback with companies, investors and other stakeholders. However, the buzz around the WEF's proposals makes clear that some investors and companies alike are eager for a consistent approach as opposed to the current fragmented regime. At the time of this publication, the final consultation paper was not yet published, but we will be watching closely to see if some of the entities that collaborated to prepare this paper will provide some of the metrics or disclosures called for by the final paper, as is currently expected.

D. Pressure on the SEC to Weigh In

The Financial Stability Board (FSB)'s TCFD recommends the inclusion of climate-related disclosures in the "annual reporting packages in which organizations are required to deliver their audited financial results under the corporate, compliance, or securities laws of the jurisdictions in which they operate." TCFD further states that it wants certain disclosure (relating to governance and risk management) to be provided regardless of materiality.

The backbone of TCFD climate disclosure is a climate risk scenario analysis, i.e., analyzing the company's operations in light of various plausible climate change scenarios. In the United States, the TCFD recommendations were called out as disclosures that ought to be mandatory in a 2018 petition to the SEC for rulemaking. The petition was signed by investors and associated organizations representing more than $5 trillion in assets under management, including large state pension funds and the U.N.-backed Principles for Responsible Investment or PRI, to which BlackRock, State Street and numerous institutional investors are signatories. In addition, Senator Elizabeth Warren (D-MA) sponsored U.S. legislation called The Climate Risk Disclosure Act, which if in the unlikely event of being adopted, would direct the SEC to issue rules requiring every company to disclose: its direct and indirect greenhouse gas emissions; the total amount of fossil fuel-related assets that it owns or manages; how its valuation would be affected if climate change continues at its current pace or if policymakers successfully restrict greenhouse gas emissions to meet the Paris Agreement's climate goal; and its risk management strategies related to the physical and transition risks posed by climate change.

In January 2020, the SEC proposed amendments to modernize and enhance financial disclosures. The proposed amendments, if adopted, touched ESG disclosures only in its proposal that companies disclose their material human capital management matters, such as attraction, retention and development of workers. Notably, these proposed enhancements did <u>not</u> include a recommendation to make the TCFD climate disclosures mandatory. In his speech discussing the proposed amendments, SEC Chairman Jay Clayton spent a great deal of time explaining why the SEC was <u>not</u> adopting mandatory climate-related disclosure. He noted that there are several characteristics of environmental and climate-related matters and related investment-oriented disclosures that are interrelated and, in his view, informed his view not to mandate additional climate-related securities law disclosures. Chairman Clayton noted:

> "<u>First</u>, the landscape around these issues is … complex, uncertain, multi-national/jurisdictional and dynamic. <u>Second</u> … capital allocation decisions based on … climate-related factors are substantially forward-looking and likely involve estimates and assumptions."

It appears that the current SEC has no appetite for mandating climate change disclosure. Accordingly, the regime will likely remain voluntary in the near term. However, even if voluntary, there remain significant legal liability implications for those who do choose to make these disclosures.

3 Legal Liability Considerations

Notwithstanding the SEC's position that it will not – at this time – mandate additional climate or ESG disclosure, companies must still be mindful of the potential legal risks and litigation costs that may be associated with making these disclosures voluntarily. Although the federal securities laws generally do not require the disclosure of ESG data except in limited instances, potential liability may arise from making ESG-related disclosures that are materially misleading or false. In addition, the anti-fraud provisions of the federal securities laws apply not only to SEC filings, but also extend to less formal communications such as citizenship reports, press releases and websites. Lastly, in addition to potential liability stemming from federal securities laws, potential liability could arise from other statutes and regulations, such as federal and state consumer protection laws.

A. Federal Securities Laws

When they arise, claims relating to a company's ESG disclosure are generally brought under Section 11 of the Securities Act of 1933, which covers material misstatements and omissions in securities offering documents, and under Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5, the principal anti-fraud provisions. To date, claims brought under these two provisions have been largely unsuccessful. Cases that have survived the motion to dismiss include statements relating to cybersecurity (which many commentators view as falling under the "S" or "G" of ESG), an oil company's safety measures, mine safety and internal financial integrity controls found in the company's sustainability report, website, SEC filings and/or investor presentations.[3]

Interestingly, courts have also found in favor of plaintiffs alleging rule 10b-5 violations for statements made in a company's code of conduct. Complaints, many of which have been brought in the United States District Court for the Southern District of New York, have included allegations that a company's code of conduct falsely represented company standards or that public comments made by the company about the code misleadingly publicized the quality of ethical controls. In some circumstances, courts found that statements about or within such codes were more than merely aspirational and did not constitute inactionable puffery, including when viewed in context rather than in isolation.[4] In late March 2020, for example, a company settled a securities class action for $240 million alleging that statements in its code of conduct and code of ethics were false or misleading.[5] The facts of this case were unusual, but it is likely that securities plaintiffs will seek to leverage rulings from the court in that class action to pursue other cases involving code of conducts or ethics. It remains to be seen whether any of these code of conduct case holdings may in the future be extended to apply to cases alleging 10b-5 violations for statements made in a company's ESG reports.

B. State Consumer Protection Laws

Claims under U.S. state consumer protection laws have been of limited success. Nevertheless, many cases have been appealed which has resulted in additional litigation costs in circumstances where these costs were already significant even when not appealed. Recent claims[6] that were appealed, even if ultimately failed, and which survived the motion to dismiss stage, include claims brought under California's consumer protection laws alleging that human right commitments on a company website imposed on such company a duty to disclose on its labels that it or its supply chain could be employing child and/or forced labor.[7] Cases have also been dismissed for lack of causal connection between alleged violation and economic injury including a claim under California, Florida and Texas consumer protection statutes alleging that the operator of several theme parks failed to disclose material facts about its treatment of orcas. The case was appealed to the U.S. Court of Appeals for the Ninth Circuit, but was dismissed for failure to show a causal connection between the alleged violation and the plaintiffs' economic injury.[8]

Overall, successful litigation relating to ESG disclosures is still very much a rare occurrence. However, this does not mean that companies are therefore insulated from litigation risk. Although perhaps not ultimately successful, merely having a claim initiated against a company can have serious reputational damage and may cause a company to incur significant litigation and public relations costs. The next section outlines three key takeaways and related best practices aimed to reduce such risks.

C. Practical Recommendations

Although the above makes clear that ESG litigation to date is often unsuccessful, companies should still be wary of the significant impacts of such litigation. The following outlines some key takeaways and best practices for companies seeking to continue ESG disclosure while simultaneously limiting litigation risk.

Key Takeaway 1: Disclaimers are Critical

As more and more companies publish reports on ESG performance, like disclaimers on forward-looking statements in SEC filings, companies are beginning to include disclaimers in their ESG reports, which disclaimers may or may not provide protection against potential litigation risks. In many cases, the language found in ESG reports will mirror language in SEC filings, though some companies have begun to tailor them specifically to the content of their ESG reports.

From our limited survey of companies across four industries that receive significant pressure to publish such reports – Banking, Chemicals, Oil & Gas and Utilities & Power – the following preliminary conclusions were drawn:

- All companies surveyed across all sectors have some type of "forward-looking statement" disclaimer in their SEC filings; however, these were generic disclaimers that were not tailored to ESG-specific facts and topics or relating to items discussed in their ESG reports.
- Most companies had some sort of disclaimer in their Sustainability Report, although some were lacking one altogether. Very few companies had disclaimers that were tailored to the specific facts and topics discussed in their ESG reports:
  - In the Oil & Gas industry, one company surveyed had a tailored ESG disclaimer in its ESG Report; all others had either the same disclaimer as in SEC filings or a shortened version that was generally very broad.
  - In the Banking industry, two companies lacked disclaimers altogether, but the rest had either their SEC disclaimer or a shortened version.
  - In the Utilities & Power industry, one company had no disclaimer, but the rest had general disclaimers.
  - In the Chemicals industry, three companies had no disclaimer in their reports, but the rest had shortened general disclaimers.
- There seems to be a disconnect between the disclaimers being used in SEC filings and those found in ESG reporting. In particular, ESG disclaimers are generally shorter and will often reference more detailed disclaimers found in SEC filings.

Best Practices: When drafting ESG disclaimers, companies should:

- *Draft ESG disclaimers carefully.* ESG disclaimers should be drafted in a way that explicitly covers ESG data so as to reduce the risk of litigation.
- *State that ESG data is non-GAAP.* ESG data is usually non-GAAP and non-audited; this should be made clear in any ESG Disclaimer.
- *Have consistent disclaimers.* Although disclaimers in SEC filings appear to be more detailed, disclaimers across all company documents that reference ESG data should specifically address these issues. As more companies start incorporating ESG into their proxies and other SEC filings, it is important that all language follows through.

Key Takeaway 2: ESG Reporting Can Pose Risks to a Company

This article highlighted the clear risks associated with inattentive ESG disclosure: potential litigation; bad publicity; and significant costs, among other things.

Best Practices: Companies should ensure statements in ESG reports are supported by fact or data and should limit overly aspirational statements. Representations made in ESG Reports may become actionable, so companies should disclose only what is accurate and relevant to the company.

Striking the right balance may be difficult; many companies will under-disclose, while others may over-disclose. Companies should therefore only disclose what is accurate and relevant to the company. The US Chamber of Commerce, in their *ESG Reporting Best Practices*,[9] suggests things in a similar vein: do not include ESG metrics into SEC filings; only disclose what is useful to the intended audience and ensure that ESG reports are subject to a "rigorous internal review process to ensure accuracy and completeness."

Key Takeaway 3: ESG Reporting Can Also be Beneficial for Companies

The threat of potential litigation should not dissuade companies from disclosing sustainability frameworks and metrics. Not only are companies facing investor pressure to disclose ESG metrics, but such disclosure may also incentivize companies to improve internal risk management policies, internal and external decisional-making capabilities and may increase legal and protection when there is a duty to disclose.[10] Moreover, as ESG investing becomes increasingly popular, it is important for companies to be aware that robust ESG reporting, which in turn may lead to stronger ESG ratings, can be useful in attracting potential investors.[11]

Best Practices: Companies should try to understand key ESG rating and reporting methodologies and how they match their company profile.

The growing interest in ESG metrics has meant that the number of ESG raters has grown exponentially, making it difficult for many companies to understand how each "rater" calculates a company's ESG score. Resources such as the Better Alignment Project run by the Corporate Reporting Dialogue, strive to better align corporate reporting requirements and can give companies an idea of how frameworks such as CDP, CDSB, GRI and SASB overlap. By understanding the current ESG market raters and methodologies, companies will be able to better align their ESG disclosures with them. The U.S. Chamber of Commerce report noted above also suggests that companies should "engage with their peers and investors to shape ESG disclosure frameworks and standards that are fit for their purpose."[12]

Endnotes

1. Leah Rozin, "ESG Risks Trickle Into Financial Filings," *NACD* (October 21, 2019).
2. The chapter is available here: https://alerts.davispolk.com/10/4452/uploads/2019-07-25-esg-in-the-us-state-of-play-and-key-considerations-for-issuers.pdf?intIaContactId=yn5qgR2eJqBcZMZpMUAZ%2fg%3d%3d.
3. See In re Equifax Inc. Sec. Litig., 357 F. Supp. 3d 1189, 1224 (N.D. Ga. 2019); Ludlow v. BP, PLC, No. 14-20420 (5th Cir. September 8, 2015); In re Massey Energy Sec. Litig., 883 F. Supp. 2d 597 (S.D. W. Va. 2012) and City of Brockton Retirement System v. Avon Products, Inc, No. 11-CIV-4665, 2014 WL 4832321 (S.D.N.Y. Sept. 29, 2014).
4. In re Banco Bradesco S.A. Securities Litigation, 277 F. Supp. 3d 600, 659–660 (S.D.N.Y. 2017); In re Signet Jewelers Ltd. Sec. Litig., No. 16-cv-6728, 2018 WL 6167889 (S.D.N.Y. Nov. 26, 2018).
5. In re Signet Jewelers Ltd. Sec. Litig., No. 16-cv-6728, 2018 WL 6167889 (S.D.N.Y. November 26, 2018).
6. As of April 2020.
7. See Sud v. Costco Wholesale Corp., 731 F. App'x 719, 720 (9th Cir. 2018); Hughes v. Big Heat Pet Brands, 740 Fed. App'x.876 (9th Cir, 2018) and Dana v. Hershey Co., 730 F. App'x 460 (9th Cir. 2018); Hodsdon v. Mars, Inc., 891 F.3d 857, 863 (9th Cir. 2018).
8. Hall v. SeaWorld Entm't, Inc., 747 F. App'x 449 (9th Cir. 2018).
9. US Chamber of Commerce, "ESG Reporting Best Practices", (November 2019).
10. SASB, "Legal Roundtable on emerging issues related to sustainability disclosure", (November 2017).
11. Note, however, that ESG raters have and may continue to come under legal scrutiny. Notably, ISS ESG was enjoined by a German court from publishing the ESG rating of Isra Vision after it received a D- (the lowest rating) from the rater. Although the judgment of the Court is not yet publicly available, media reports suggest that when granting the preliminary injunction, the court reasoned that the mere lack of information could not justify a low ESG rating of a company.
12. US Chamber of Commerce, "ESG Reporting Best Practices", (November 2019).

Katherine J. Brennan serves as Deputy General Counsel, Corporate Secretary & Chief Compliance Officer at Marsh & McLennan Companies, Inc. Prior to re-joining Marsh & McLennan in October 2017, Kate served as the Senior Vice President, Deputy General Counsel and Corporate Secretary at S&P Global Inc. From 2008 to 2015, Kate served in a number of leadership roles at Marsh & McLennan, including General Counsel of Guy Carpenter, Senior Corporate Counsel and Assistant Corporate Secretary.

Marsh & McLennan Companies
1166 6th Avenue, NY
NY 10036
USA

Tel: +1 212 345 5000
Email: katherine.brennan@mmc.com
URL: www.mmc.com

Connor Kuratek is Chief Corporate Counsel and Assistant Corporate Secretary at Marsh & McLennan Companies, Inc., where he is responsible for public disclosures, M&A, and securities and other strategic corporate transactions for the company and its operating companies. Connor also serves as Chair of the Marsh & McLennan Disclosure Committee and Secretary of the Audit Committee of the Board of Directors. Prior to joining Marsh & McLennan in 2016, Connor was a capital markets associate at Davis Polk in New York.

Marsh & McLennan Companies
1166 6th Avenue, NY
NY 10036
USA

Tel: +1 212 345 5000
Email: connor.kuratek@mmc.com
URL: www.mmc.com

Joseph A. Hall is a partner in Davis Polk's Corporate Department and co-head of the firm's Environmental, Social and Corporate Governance group. His transactional practice includes advising companies and investment banks on initial public offerings, block trades and investment-grade, high-yield and convertible-debt offerings, as well as advising crypto-asset managers on fund formation and distribution. His advisory practice includes advice with respect to sensitive C-suite and board matters, corporate governance matters generally, public company reporting obligations, securities law compliance and the regulation of credit rating agencies. He is a frequent speaker and author on topics of corporate governance and capital markets practice.

Davis Polk & Wardwell LLP
450 Lexington Avenue NY
NY 10017
USA

Tel: +1 212 450 4000
Fax: +1 212 701 5800
Email: joseph.hall@davispolk.com
URL: www.davispolk.com

Betty Moy Huber is co-head of Davis Polk's Environmental, Social and Corporate Governance Group. She advises public and private companies and their boards on the full range of corporate governance matters, including stakeholder engagement, shareholder activism, board composition and refreshment, fiduciary duties, board assessments, reporting and disclosure requirements and shareholder proposals. She also advises her clients on institutional investor and proxy advisory firm policies, trends and "best practices" in proxy statement and voluntary disclosure, ESG policies, corporate culture and rating organizations.

Davis Polk & Wardwell LLP
450 Lexington Avenue NY
NY 10017
USA

Tel: +1 212 450 4000
Fax: +1 212 701 5800
Email: betty.huber@davispolk.com
URL: www.davispolk.com

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