Lead Director Network
ViewPoints
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The board's role in overseeing innovation

Innovation has become an essential capability for any large public company if it wants to remain competitive. With some studies suggesting that 50% of the companies in the S&P 500 list could be replaced over the next 10 years,[1] innovation may even be critical for survival. Yet innovation can be uncertain and costly, putting profits at risk. How can boards ensure that companies are innovating sufficiently and effectively?

Lead Director Network (LDN) members met on March 21 in Washington, DC, to discuss how the board oversees innovation. This issue of *ViewPoints* synthesizes that discussion and conversations leading up to it. It also summarizes a discussion about potential tax and trade policy changes by the Trump administration.[2] For further information about the LDN, see page 8. For a list of participants, see Appendix on page 9.

When and where should boards get involved with corporate innovation?

Innovation is a term encompassing many kinds of activities, including efforts to improve operational efficiency and the development of new products and services. Even a narrower concept of technology-driven innovation comes in many flavors. As one LDN member put it, *"There's a difference between something truly disruptive and just a new way of doing business."* Indeed, it is possible to chart a hierarchy of innovation that starts with companies meeting basic requirements to stay in business, moves up to increasing productivity and enhancing competitive advantage within existing products and services, and culminates in developing new product lines and markets. At the highest level, innovation can transform or even create an industry.

Each level of innovation has different ramifications for companies and industries, and each is likely to require different kinds of board engagement. As LDN members noted, boards cannot cross the line into management; but are there times when close involvement with specific initiatives becomes necessary? And are there general aspects of innovation that boards should consider? LDN members proposed several areas in which boards play an important role: promoting strategic innovation, selecting the right CEO, encouraging employees to innovate, and maintaining guardrails on innovation.

Promoting and guiding strategic innovation

Innovations resulting in major industry disruptions or shifts in a company's business model are issues of utmost strategic importance, requiring close board involvement. As an LDN member said, *"With companies being disrupted, it's the board's role to constantly ask how the industry will change. Who will disrupt us? How can we disrupt ourselves? Skunkworks are the CEO's job, unless it leads to the overarching issue of how we are going to disrupt ourselves."* Another member said: *"If you look at the statistics, the world is changing at a rate that's like nothing we've seen before. Irrespective of the industry,*

[1] Ilan Mochari, "Why Half of the S&P 500 Companies Will Be Replaced in the Next Decade," *Inc.*, March 23, 2016.

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

every board has to ask how that might change who we are. If companies don't see that, they will be casualties."

A member noted that the board's emphasis on pushing the company forward might vary depending on management's inclinations: *"The board's role is affected by the CEO's role. With a CEO that is not forward-leaning, the board's role is to poke and prod and point. If the CEO is forward-thinking, the board's job is to keep pace with the CEO to provide insight."*

Selecting the right CEO

LDN members agreed that one of the most important concerns regarding innovation is the leadership at the top of the company, especially when major changes are involved. *"The bigger question is, Does the CEO have the wherewithal to lead us through this transition?"* one member remarked. Another explained, *"The board can't run the company even if it tried. It's all about if you have the right CEO. You have to have an effective relationship. You need a forthright CEO."*

When selecting a CEO, members look at candidates' abilities to lead innovation. The process can be in-depth and time-consuming, as one member explained. *"We spent a full year with directors having two one-on-ones with each candidate, and then we teamed up to discuss them. Each member asked about individual areas of expertise. We asked in detail about how to change and stay fresh."* Another member also described spending considerable time to find a person with technological expertise, noting, *"It was a critical factor in the process."*

Yet members also acknowledged a quandary: how can the board balance technological expertise with the other requirements of the CEO role, especially when technological expertise is often scarce?[3] One member said, *"We've been in this revolution for 30 years. Four or five years from now, things could be completely different. You need to pick someone with broader, fundamental skills, with the ability to manage the change that's coming."*

Encouraging employees to innovate

In addition to worrying about the strategic initiatives that could – in and of themselves – make or break a company, boards also need to consider how the company manages smaller, more incremental innovations that could add up to significant competitive advantages. The board cannot go into the details of these more numerous initiatives, but it can assess the environment that generates and supports them.

Directors can do more than simply observe the company's culture. An LDN member described a specific program for recognizing innovators at all levels: *"Innovation encompasses the big and the small. One role of the board is to have a broad definition. It needs to encourage innovation, look for it, and incentivize it.*

[3] Experts on innovation governance have discussed the same quandary. See, for example, Jean-Philippe Deschamps, "Governing Innovation in Practice – The Role of the Board of Directors," *InnovationManagement.se,* May 2013.

We nominate people for an innovation award. We select five to 10 people and have them come to the board, joining us for dinner. Everybody knows that the board is looking for innovation."

The board can also be alert to problems in the culture, as another member explained. *"At the first board I was on, every time I asked a question, I would get a call from the CEO. He judged his managers on how many questions they got. So managers were very defensive. The board's role is to make sure there's a lot of openness, that you can have the zany discussions – and that the CEO builds that throughout the organization. If management is defensive, there are signals. Maybe our role is overseeing the culture as it relates to innovation."*

A member remarked on the benefits of embedding staff who are driving innovation in customer-facing business units, allowing scientists and engineers to partner actively and continuously with more business-oriented staff: *"Rather than a stand-alone unit, you have a science unit in the line of business so the partner can serve as an enforcer and help navigate the corporate minefield. Usually the scientists don't have the business experience and credibility to stand up and say, 'You're not doing what I tell you.' "*

Maintaining guardrails on innovation

While promoting innovation is of paramount importance, LDN members also discussed the benefits of ensuring that the innovation process includes checkpoints and guardrails along the way, aligned with the company's risk appetite. A member explained, *"At one of my companies, there are big ideas, and the board gets it, but the effort is new for the company, so the board has asked for a more stepwise approach and proof of concepts. I hope we're not restraining the innovation too much, but we did put a paradigm on it. We also developed some new investment criteria."*

Another member described a company's approach to keeping the passion of its engineers in check: *"On a program of any magnitude, we put together a separate group of people that looks at the costs and issues, and they have to be satisfied that the program will be competitive. Recently, we had a group look at a joint project with another company, and they recommended that we stop. We always look at programs over a certain cost, just to have people who are not emotionally involved."* A few members also brought up metrics for evaluating the overall success of innovation programs, such as the Vitality Index, which measures revenue from new products as a percentage of total revenue.

At the same time, a member acknowledged the difficulty of measuring the impact of more transformative innovations: *"The challenge for the board is that huge amounts of money are being spent, but you can't measure it all. The question is, Is it enough? You can't reduce it to a pure [return on investment] because innovation changes everything."*

Even when a company is moving in the right direction, the board might consider the possibility that moving more slowly would be wise. A member explained: *"An important dimension is that you need to be correct about the change but also the pace. Particularly for incumbents in an industry, venturing away from the core may be risky. You've got to get it right, and get the timing right. If you're a shaper of the* *market and responding to innovation, you can leave a lot of latent value behind if you go too quickly. We need to encourage management to take risks, but also have boundaries."*

How can the board oversee innovation more effectively?

Innovation that is based on or driven by new technologies can be difficult for a non-expert to assess. Boards are acutely aware of the challenge, and LDN members discussed their attempts to strengthen board capabilities, particularly through the composition of the board, the processes used to oversee innovation, and director education.

Board composition

Many boards today consider recruiting a director with significant technological expertise – a so-called "digital director." Yet the benefit of recruiting such a director – or other directors with expertise in specific areas – remains a topic of debate. A 2016 analysis by Russell Reynolds Associates found that the percentage of companies in the Fortune 500 that had a technology expert on the board varied significantly by company size: 39% of the 100 largest companies featured such an expert on their boards, yet only 13% of the last 100 companies on the list did the same.[4] Not surprisingly, boards in the technology, media, and telecommunications sectors were far more likely to include a technology expert than boards in other sectors (93% vs. 26%–30%).[5]

Several LDN members noted that directors' general capabilities must not be forgotten. One member said, *"You want someone who is a good board member but then has technological expertise as well."* Another remarked, *"They need the capacity to be a great director, not just a great digital director."* Because technology advances quickly, specific knowledge may be less important than a desire to learn. *"That's why we never lose the great director angle. We need someone who shows the passion to stay abreast of things, who is plugged in to startups, and who will not necessarily bring the answers, but the right questions."*

Other members echoed the point: *"The concept of the digital director went off the rails because we didn't think about their other responsibilities. If you're in an industry with lots of change, you need them. But you have to enable them to be an effective voice."* One member shared this experience: *"We hired a digital director. He was like a hammer trying to find a nail. The wisdom was only the Valley. They are really smart there, but they are sure they're always right. You almost have to wait until they mature."*

One member recounted a recent experience with less seasoned directors: *"I had the opportunity to go on the board of a spinoff. There were five new directors. The meetings were an absolute disaster – they wanted to tell management how to proceed. They will eventually be good directors, but today they don't understand their role. It's a train wreck about to happen."*

Another member returned to the task of nurturing the right culture, a challenge that requires deeper understanding of success and failure: *"All innovation doesn't work, so you need to get the right culture.*

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[4] David Finke and Miki Carlton, *The Rise of the Qualified Technology Executive in the Boardroom* (Russell Reynolds Associates, 2016), 4.

[5] Ibid.

You need people with experience and wisdom who have seen it. How to handle innovation failure is very important – you could stifle innovation for the next generation."

Some members, however, mentioned a willingness by the board to take risks in recruiting a director. One member reported positive results from recruiting directors without prior board experience: *"We're going beyond looking for people with direct experience. We lost an excellent director, but we asked him to clone himself. He found someone with a [non-traditional] background. After six months, she realized we were aligned, and she turned into a great director."* In a pre-meeting conversation, another member discussed strategies around vetting and introducing directors who lack real board experience: *"If you bring someone like that in, you need to be careful with the onboarding process. The board needs to be aware and not recoil. The [nominating and governance] committee needs to be open about who's coming on board. Some boards use a think tank or advisory board as a way to get input and see if someone can be on the board itself. We have to understand what we're getting or not getting."*

Processes for overseeing innovation

Every board struggles to understand what is really going on in the company, and this may be especially true for innovation activity. One member said, *"It is really difficult in today's environment to understand what innovations make a real difference at the customer level."* How can boards effectively gather and digest information about innovation?

Again, candid conversations with the CEO are critical, one member said: *"It's about making sure you have one-on-one time with the CEO. What's worrying you? What are the trade-offs? They are more candid than if the whole management team is there. You need a trustful, candid relationship."*

But members also described ways in which information can be channeled from lower levels of the organization to enhance the board's understanding. The board needs to be briefed by people at the front lines of innovation: *"It's about finding people within an organization and making sure to give them opportunities to translate for the board what they see as impending change. It's very hard to understand the cutting edge of innovation. It takes a lot of time to explain what is going on. You need to provide time to educate people … You need to get people in front of the board who are close enough to where the rubber hits the road."*

Another member said, *"We have a culture where the lowest level can voice concerns through our hotline."* One member said field visits can be helpful up to a point: *"Otherwise, you never get a sense of how capital allocation is implemented, how morale is, etcetera. But even with the visits, it's limited – everyone is on their best behavior, there's fresh paint."*

Regarding deliberation within the board itself, a member mentioned focusing on innovation at the annual off-site meeting: *"We have the traditional off-site, with executive sessions where we spend significant time with just the CEO. We discuss the business environment and make sure each director knows our purpose and capabilities. It's about getting everyone on the same page regarding weaknesses, strengths, and our direction."*

At the same time, innovation has to be an ongoing discussion: *"Strategy is now a year-round issue. You fit things into a larger context. It's good to see other things against strategy. We interject other strategic deep dives. Most boards understand that strategy is more than incremental – that it's about long-term views. You don't set it and walk away from it – you constantly engage with strategy. It's an evergreen process."* That commitment might require extra effort, a member said: *"We all run up against the fact that we only meet four times per year. That's our problem – we shouldn't be locked into that. Some boards are expanding their time to cover things. It's entirely within our control."*

LDN members said that they value dissenting views, whether they originate outside the company or are generated within the board. A member mentioned bringing in the one analyst who was not bullish on the company to find out why. Another suggested that the tone of meetings could be more conducive to candor: *"You get contrary views in the room in a safe way, establishing an environment where that kind of thought process can be encouraged. It's about getting those who don't speak up to speak."*

Using technology committees

Some LDN members endorsed the use of technology committees as a way to focus the board's oversight of innovation. One member said, *"We created a technology committee, which had two areas of focus: big T, and also the specifics of technology strategy. It was an open committee; I wasn't on it, but I went to every meeting."* Another member noted that since some aspects of innovation – in particular, risk-related elements – are addressed by the audit committee, coordination between the two committees is required: *"Our technology committee chair is also on the audit committee, so they understand the overlap and make sure there are no gaps."*

A majority of members' boards, however, do not have technology committees. In one member's case, a technology committee served in a more transitional role and was eventually disbanded: *"It was partly workload balance – making sure people weren't on too many committees – but also there seemed to be enough clarity that we could make it part of the regular board activity."* Indeed, the above-mentioned Russell Reynolds Associates analysis found that only 33 Fortune 500 companies (just under 7%) had a separate technology committee.[6]

Director education

A member noted that having one or two designated technology experts on the board is not sufficient for effective oversight: *"There needs to be a minimal understanding by the entire board, and it needs to be carefully executed over many years."* In addition to understanding the company's innovation efforts, LDN members said that a board benefits from broader understanding of technology and its impact on adjacent industries.

[6] David Finke and Miki Carlton, *The Rise of the Qualified Technology Executive in the Boardroom* (Russell Reynolds Associates, 2016), 6.

One member acknowledged that most education is personal: *"The board stays informed outside the board room. It's what the directors read and the other boards they are on."* At the same time, the board as a whole can be educated in a more formal fashion about relevant trends. At one member's company, *"competitive information is provided to the board, including monthly updates reviewing everything going on in the industry, with a broad definition of industry; the board gets extensive information."*

A member described some approaches to educating the board: *"In one board, we brought in consultants and speakers to talk about pertinent technological issues. In another, we had a speaker and signed up members in CISR [Center for Information Systems Research] at MIT. That proved effective."* One member described a more pointed exercise focused on the company's exposure to disruption: *"We use a devil's advocate approach. We appoint someone to tell us how they will wreck the company. In public companies, we use consultants. We hire a consultant to write an activist letter to the board. It's startling but also constructive."*

Conclusion

Innovation and disruption can unleash complex, unpredictable, and even chaotic forces, forces that can dramatically affect companies. LDN members agreed that boards can help management navigate the opportunities and risks that innovation presents. As one member noted, *"We need to have a conversation about how we will be relevant, where the business is going."* Ensuring that the CEO can take the lead is critical. At the same time, boards can also weigh in on the overall culture of innovation and the processes that produce more incremental progress as well as transformative change. To play these roles effectively, the wisdom of directors with broad business experience remains important, even as boards seek expert insights and perspective from within and outside the company.

Review of the new administration's trade and tax policies

Steve Orava and Hap Shashy of King & Spalding gave LDN members an overview of where the Trump administration might go in two policy areas that are key for large global companies: trade and tax. Mr. Orava noted that the administration is pushing an "America First" approach to trade, which seeks to increase growth, promote manufacturing, and defend sovereignty by focusing more on bilateral deals that fully leverage US economic might. The metric of success will be a narrowing of the trade deficit. Given the threat of retaliation by other countries, however, and the fact that many in Congress – and in the business community – still support free trade, this new approach might be toned down significantly as it churns through the legislative process.

In the area of tax, Mr. Shashy said that the goals for the first comprehensive tax reform in 30 years are lower rates, simplification, and easier repatriation of overseas earnings, all objectives that have broad support. However, one springboard for the effort, the blueprint developed last summer by House Speaker Paul Ryan and Ways and Means Committee Chair Kevin Brady, includes the *"revolutionary"* proposal of a border adjustment tax. This tax on imports would raise considerable revenue, but it would also raise a lot of political, technical, and implementation issues. It would create clear losers as well as winners, and it might violate tax treaties and World Trade Organization rules. As with trade policy, the ultimate outcome remains unclear. The only certainty is that the tax reform debate will be great for lobbyists.

Appendix: Participants

The following directors participated in the meeting:

- Dick Auchinleck, Lead Director, ConocoPhillips; Non-Executive Chair, TELUS
- Peter Browning, Lead Director, Acuity Brands
- Jaime Chico, Lead Director, Honeywell
- Sandy Cloud, Lead Director, Eversource Energy
- Mark Feidler, Lead Director, Equifax
- Don Felsinger, Lead Director, Archer Daniels Midland and Northrop Grumman
- Ann Fritz Hackett, Lead Director, Capital One Financial Corporation
- Linda Fayne Levinson, Lead Director, Jacobs Engineering
- Mike McCarthy, Lead Director, Cabela's and Union Pacific
- Sam Nunn, Lead Director, Coca-Cola
- Larry Thompson, Lead Director, Southern Company

The following King & Spalding partners participated in all or part of the meeting:

- Bobby Burchfield
- Dixie Johnson
- Steve Orava
- Hap Shashy
- Cal Smith
- Chris Wray