

# **An Open Letter to Independent Sector on its Draft Principles of Self-Regulation**

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January 24, 2007

Our colleagues at Independent Sector have issued 29 draft “principles of self-regulation” as part of the Panel on the Nonprofit Sector convened by IS at the request of Max Baucus and Charles Grassley, Chairman and Ranking Member of the Senate Finance Committee. See [here](#). IS says that its draft principles would apply to all public charities with annual revenues of \$1 million or more and to all foundations with assets of at least \$25 million.

The Philanthropy Roundtable applauds Independent Sector and the Panel on the Nonprofit Sector for their tireless and well-organized work to improve nonprofit governance, board financial oversight, fundraising practices, and compliance with the law, all subjects of the draft principles. The Roundtable also appreciates IS’s spirit of openness in making its draft available and inviting comments from others.

However, The Philanthropy Roundtable has two levels of concern about the Independent Sector draft principles of self-regulation. First, we fear that some of the draft principles take a “one-size-fits-all” approach to setting rules for a very diverse sector, or would require private organizations to reveal publicly their internal decision making processes.

Second, we are concerned about how the proposed principles would be administered and enforced. Independent Sector doesn’t explain what it means by “self-regulation.” And there are some forms of self-regulation that would be seriously harmful to the foundation world and to charitable giving.

## **Concerns about the Draft Principles**

Let us turn first to our concerns about specific draft principles. While most of the proposed principles are quite sensible, some apply a “one-size-fits-all” approach to charities and foundations that have diverse objectives and circumstances. For instance, Draft Principle #7 says that “The board [of a charity or foundation] should hold at least three meetings per year.” Draft Principle #8 says that “The board should have a minimum of five members.” And Draft Principle #17 says that “Board members are generally expected to serve without compensation, other than reimbursement for expenses incurred to fill their board duties.”

These proposals unnecessarily restrict the ability of donors and trustees to use their best judgment in how to carry out their charitable objectives. There are many foundations, including most prominently the Bill and Melinda Gates Foundation, whose boards do

excellent work with fewer than five members. So, too, there are many foundations and charities whose boards do not need as many as three meetings per year to perform their responsibilities effectively.

As for compensation, within the foundation world there is both a long and venerable tradition of volunteer board service and also a long and venerable tradition of compensated board service. Our experience at The Philanthropy Roundtable suggests that philanthropic excellence is common in both traditions—and so is philanthropic mediocrity—and that self-regulation should not favor one tradition over the other. Whether to compensate board members of foundations is a judgment call best left to donors and the individuals to whom they have entrusted their charitable resources, subject of course to rules against self-dealing enforced by the Internal Revenue Service.

The Philanthropy Roundtable is concerned in addition by the violation of privacy suggested by Draft Principle #6: “A charitable organization must make information about its operations, including board members, finances, programs and activities, and methods used to evaluate outcomes of work [our emphasis], widely available to the public.” How a foundation determines its philanthropic strategy—how it makes decisions about which grants to make, and how it evaluates performance by grant recipients—is an inherently private decision by a private organization. Foundations should feel free to reveal their grant-making strategy if they wish, and many find it in their interest to do so, but it is an unnecessary breach of privacy to compel them to do so.

Foundations are private organizations that benefit from the tax exemption. Public policy has therefore set certain minimum disclosure requirements to ensure that foundations are in fact complying with the tax laws. For instance, foundations have to disclose their grant recipients, and this helps to ensure that their grants go to bona fide charitable organizations. They have to disclose their board members, compensation, and investments, in order to help guard against unreasonable compensation and self-dealing. But public policy has otherwise protected the private decisions of private organizations.

Grant-making strategy and evaluation properly falls in this zone of privacy. So long as a foundation is making grants to legitimate public charities, there is no reason tax authorities or watchdog groups need to know why it is choosing some grantees over others. Quite the contrary, maintaining privacy enables foundations to exercise their honest judgment on this most sensitive of judgment calls. Maintaining privacy also protects the grant applicants not chosen and allows foundations to provide them with confidential advice.

### **Caveats about Self-Regulation**

The term self-regulation is ambiguous. In releasing its draft principles, it is unclear whether Independent Sector is encouraging the growth of voluntary standard-setting, self-assessment, and accreditation within the nonprofit world, or whether it is encouraging

mandatory industry-wide rule-making, with the rules being made by representatives of the nonprofit industry.

The co-chairman of Independent Sector's Advisory Committee on Self-Regulation of the Charitable Sector, Joel Fleishman, calls for such a mandatory form of self-regulation in his new book, *The Foundation: A Great American Secret*. More specifically, Fleishman calls for the Internal Revenue Service to delegate much of its rule-making and enforcement authority for policing foundations to a new private industry-based regulatory agency modeled on the brokerage industry's National Association of Securities Dealers (NASD).

A variation of this proposal, suggested by the Senate Finance Committee staff in its 2004 discussion draft on the charitable sector, would be the enactment of legislation making tax-exempt status for foundations and public charities contingent on private accreditation. This would have the potential to be a much more subjective and onerous process than IRS approval of 501(c)(3) status.

If Independent Sector's purpose in drafting principles of self-regulation is simply to educate charities and foundations about best practices in the field, The Philanthropy Roundtable applauds its initiative. In addition, if IS wants to set eligibility standards for its own membership, or to give guidance to other voluntary associations that want to establish codes of conduct or self-assessment procedures for their members, the Roundtable has no problem with such an exercise. It is consistent with the principles of a free society for private membership organizations to establish governance standards, codes of conduct, and accreditation policies, so long as individual foundations are free to join or not join as members.

However, while foundations should be free to participate in voluntary accreditation or certification programs if they wish, the Roundtable is strongly opposed to any requirement that accreditation be a condition of tax-exempt status. An accreditation requirement could pose a very serious threat to independent thought in philanthropic foundations. We have seen this in the case of college accreditation, where Thomas Aquinas College of California was initially denied accreditation in the early 1990s by the regional accreditation monopoly—a private non-governmental group—because the accreditors didn't approve of the college's Great Books curriculum.

Moreover, accreditation simply isn't necessary for foundations. There is a public-interest rationale for accrediting hospitals or, perhaps, day care centers—where health and safety issues are at stake. Public charities may also find it helpful to be certified or accredited on a voluntary basis in order to win the confidence of donors. (The Evangelical Council for Financial Accountability is an excellent example of a voluntary certification process that has dramatically improved governance and financial integrity among its constituents.) Foundations, however, are not taking investments from others, nor are they entrusted with the safety of members of the public. Indeed, so long as they obey the law, foundations do not have to be and should not have to be directly accountable to anyone except their own trustees.

In addition, The Philanthropy Roundtable will strongly oppose the creation of a new private industry-wide rule-making and enforcement agency modeled on the NASD and under the supervision of the IRS. There are four reasons for our opposition:

First, the danger of over-regulation can be just as great under private as under public rule-making and enforcement bodies. For instance, the private-sector nonprofit Public Company Accounting Oversight Board (PCAOB) has been largely responsible, together with the Securities and Exchange Commission which selects the PCAOB board, for the nightmare regulations under the Sarbanes-Oxley Act that have discouraged independent public offerings in American securities markets and led to a flight of publicly held companies overseas and into private equity. Senator Charles Schumer and Mayor Michael Bloomberg have recently warned that New York City is in danger of losing its financial pre-eminence in part because of over-regulation under Sarbanes-Oxley.

Second, creation of an NASD-like self-regulation entity would amount to double-taxation. Foundations already pay an excise tax that is supposed to provide the IRS with revenue to police the tax-exempt sector, though only a small portion of the proceeds actually go to this purpose. Foundations would have to be taxed or dunned a second time to finance the new self-regulating body. It would make more sense to apply the proceeds of the excise tax to the purpose for which it was intended, and give the IRS tax-exempt bureau the resources it needs to police the nonprofit sector. Indeed, until we have a chance to observe a fully funded IRS tax-exempt bureau in operation, there is no case for establishing a second regulatory agency.

Third, the culture of the IRS is dedicated to protecting the privacy of those it is investigating. This is a valuable safeguard against the introduction of politics and the abuse of power by enforcement authorities, and it could well be lost if enforcement were delegated to a separate regulatory agency.

Fourth, creation of a self-regulating body could encourage cartel-like behavior—the use of the rule-making process by politically powerful existing philanthropic leaders to exclude competition from new entrants. This is not an idle threat. Already prominent nonprofit leaders have made proposals to abolish foundations with small asset sizes, or to require family foundations to have independent directors. Creation of a new regulatory agency, especially one controlled by the industry, would provide a vehicle for enacting such rules.

There are some in the nonprofit world who favor formal industry-wide self-regulation as an alternative to misguided proposals for a dramatic expansion in federal and state oversight. The Philanthropy Roundtable does not share this view. We believe that existing laws should be more vigorously enforced, that some narrowly tailored new laws may be necessary to correct specific abuses, and that overreaching legislative proposals can be and should be resisted on their own merits, without substituting a private self-regulatory regime that could be equally overreaching and intrusive.

To read the Independent Sector's Draft Principles on Self-Regulation, [click here](#)

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