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OPINION

The Accountability Toolbox

Sector must nix the either-or mentality towards government regulation and self-regulation

By Rick Cohen

Apocalyptic fears of governmental oversight drive many in the nonprofit sector to envision a nirvana of self-regulation.

A foundation executive described the either-or scenario for self-regulation as a matter of choice or will: "Sooner or later, foundations are going to have tougher oversight. The question is whether we will take the initiative ourselves or wait to have something foisted upon us by a knee-jerk response to public outrage over some real or perceived case of excess or abuse."[1]

This is a sort of rugged individualist interpretation of nonprofit and philanthropic accountability: Either take responsibility or succumb to mindless ("knee-jerk"), irrational ("public outrage") governmental oversight.

The nonprofit self-regulation story involves dispelling myths and examining real experience of self-regulation in the United States and elsewhere.

Self-regulation exists: The U.S. nonprofit sector is basically self-regulated, and institutional philanthropy is nearly untouched. Witnesses in last year's Senate Finance Committee hearings and subsequent roundtables on nonprofit accountability unanimously observed the scant governmental oversight of the sector from the Internal Revenue Service (IRS) and state charity offices. The tax-exempt division of the IRS is seriously underfunded, barely capable of reading the mammoth 990-PFs big foundations submit and much less competent at investigating the information they contain. The 145 audits and reviews of foundations[2] and 3,396 reviews of tax-exempt organizations filing 990s and 990-PFs conducted by the IRS[3] in 2003 demonstrate that few nonprofits may actually be investigated for their financial probity.[4]

The capabilities of state attorney-general offices do not compensate for federal limitations. For the most part, state governments focus rather narrowly on charitable solicitations. At best, only a dozen or so states possess active charity offices, only a few have more than a handful of staff,[5] and most are incapable of going after the bigger miscreants. Indeed, the lack of oversight and enforcement resources at the state level is such that only occasionally do attorneys general Eliot Spitzer of New York, Lisa Madigan of Illinois, and Bill Lockyer of California get involved in philanthropic cases.


Rick Cohen

The absence of government oversight does not mean that the nonprofit sector is eagerly filling the gap on its own. It is difficult to think of any examples of nonprofit malefactors being drummed out of the membership rolls of national infrastructure organizations. As the brouhaha at Independent Sector (IS) around a proposed article for an online IS "Memo to Members" by the Minneapolis Foundation's Emmett Carson demonstrated, the mere mention of certain IS members in the article (the Irvine Foundation, Red Cross, Nature Conservancy, and United Way) ran afoul of a kind of nonprofit *omerta*. Rejected by Independent Sector, Carson's article was eventually published without censorship in *The Chronicle of Philanthropy*.

For the most part, with minimal government oversight and limited sector willingness to boot out bad guys, nonprofit self-regulation largely falls to nonprofit board members. Self-regulation, such as it is, is also occasionally abetted by members of the donating public, provided they are knowledgeable enough to use the information provided by rating organizations such as the BBB Wise Giving Alliance, Charity Navigator, and American Institute of Philanthropy.

Not either-or: Nonprofit accountability is not a choice between the mutually exclusive options of government regulation and self-regulation. Somewhat less hysterical about oversight, the Canadian nonprofit sector offers this useful interpretation:

"Accountability should be thought of as a toolbox, rather than as a single approach for the exercise of responsibility. In this light, we have interpreted accountability broadly to include mechanisms of stewardship by boards of directors, self-accreditation by organizations, self-regulation by the sector, and external regulation."[6]

There are some aspects of nonprofit governance that can only be addressed by nonprofit organizations themselves. There are other dimensions that require the government's involvement, and there are some functions that are legitimately shared between the sector and government. While right wingers bemoan the Senate Finance Committee's attention to nonprofit accountability, the sector will have to draw on self-regulation as one of its accountability tools, no matter what Congress, the IRS, or state governments do.

As for the self-regulatory elements, the challenge will be how much teeth to give them.

Dimensions of accountability: The challenge of nonprofit accountability is that nonprofits share so little beyond their shared 501(c)(3) legal status. There are distinctions between grantmakers and grant recipients, distinctions between large nonprofit behemoths and small local service providers, and differences among nonprofits by topical focus: community development, health provision, environmental conservation. In other words, what works for land trusts on some issues might not work nearly as well for hospitals and universities and vice versa.

Equally important, different kinds of regulatory schemes fit parts of nonprofit functions better than others. Government seems to have little or no role in the accountability of a nonprofit that is drifting away from its mission, but the board of directors certainly does. And if the board doesn't act, the stakeholders themselves—the nonprofit's consumers and partners—may have to take matters in their own hands.

Within the nonprofit sector, observers estimate that only 20 percent of nonprofits belong to professional or trade "umbrella" organizations. Alternatively, some nonprofits are members of more than one umbrella organization, thus raising the question of whose standards a nonprofit should follow.

Mechanisms of self-regulation: Self-regulation is not purely an alternative to government oversight, but rather should be viewed as different mechanisms, such as these:

> Accreditation and licensing: For the public, accreditation of nonprofits (and some for-profits) is well-known in higher education. Indeed, colleges and universities, and their programs, may be accredited by one or more of 60 regional or national accrediting organizations.[7] The Council for Higher Education Accreditation (CHEA) actually coordinates the array of voluntary accreditation programs aimed at distinguishing legitimate schools from diploma mills. Well-known accrediting organizations include the American Bar Association (ABA) for law schools and the Association of American Medical Colleges. For the purpose of this article, these are classified as accreditation and licensing entities in that they review not only the financial and management practices of organizations, but also the content of programs and in some cases curricula. More than a seal, the accreditation is a sort of license to practice or operate.

> Codes of practice: Among generic nonprofits, the Maryland Association of Nonprofit Organizations (MANO) is the most recent to promulgate a code of practice to evaluate Maryland nonprofits. One of the nation's most impressive is the Seven Standards of Responsible Stewardship of the Evangelical Council for Financial Accountability (ECFA).[8] ECFA describes itself as an accreditation agency in that its nearly 1,200 nonprofit Christian ministry members have to comply with the ECFA standards to maintain membership status. ECFA also enforces standards annually by requiring submissions of audits and other information, conducting field reviews of 10 percent of its membership, and investigating reported complaints about noncompliance. Other trade associations such as the Council on Foundations (COF) promote codes of behavior like ECFA's, but rely on their members' self-reporting.

> Education (for consumers as well as producers): Some organizations believe and advocate that education for nonprofits, particularly for nonprofit board members, is the best and most cost-effective mechanism for nonprofit accountability. In that sense, recent shifts in the public focus of the New York Attorney General's office—away from legislative initiatives and toward public education—have garnered support and sighs of relief from anti-regulation nonprofit leaders. On nonprofit accountability issues, educated boards of directors are in all probability the

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strongest operational mechanisms of self-regulation in the sector.

> Ratings and evaluations: BBB Wise Giving Alliance, Charity Navigator, and the American Institute of Philanthropy are well-known generic nonprofit ratings organizations. Each relies more or less on 990s—and, in some instances, excerpts from organizational audits plus supplemental information submitted by nonprofits—to rate nonprofit accountability. This information usually emphasizes fundraising costs, administrative costs, and structural aspects of nonprofit governance.

> Co-regulation: There are more and more examples of co-regulation occurring in the for-profit sector, where government essentially shares with the sector the task of developing and enforcing standards. Unlike self-regulation, the government imprimatur provides some legal protection against stakeholder litigation for organizations complying with co-regulation standards. With co-regulation, nonprofits would have more input into the interpretation of the rules than they would with government regulations.

Co-regulation merits special attention for its shared responsibility for oversight and governance. There are several models:[9]

> Government adopts and incorporates part of a trade association's standards of behavior in the government's legally enforceable regulations.
> Government recognizes a sector's or an association's code of behavior and passes legislation adopting it as the public's enforceable standard.
> Government mandates that a trade or professional association create a code for subsequent oversight and enforcement.
> Government officially delegates its oversight and enforcement authority to a professional or trade association.

Abuses of self-regulation: Much of the nonprofit sector's advocacy for self-regulation is based on the charitable, or "do-gooder," intent of the players. But as scandals at the United Way of the National Capital Area, Pipevine, and other United Way affiliates demonstrate, the positive intent of most of the 1,400 members of the United Way (UW) did not mean that the system worked to clean up abuses. To the contrary, some would suggest that the United Way's first line of response to the National Capital scandal and other instances where United Ways engaged in double counting and other irregularities was press-oriented damage control, before finally succumbing to the realization that the UW accountability system needed a drastic overhaul. Nonprofit history dentifies many pitfalls of self-regulatory schemes:

> Self-regulation requires resources for investigation and enforcement that would be no less than a governmental agency would provide. The mere promulgation of sectoral standards accomplishes little if the sector lacks the organizational and financial resources to investigate compliance and enforce the standards. Given 1.4 million nonprofits, just the annual cost of doing organizational analyses and creating ratings along the lines of the work of the BBB Wise Giving Alliance or the American Institute of Philanthropy is enormous. No one should presume that self-regulation is a no-cost alternative to the IRS and state attorneys general.

> The history of self-regulation demonstrates that the more powerful actors in the market tend to be the most influential in structuring the rules, frequently for self-interest. In this nation's nonprofit infrastructure, which includes organizations such as the COF and IS, the larger foundations and larger nonprofits dominate and influence the substance and content of standards more than smaller organizations, not to mention those that are not members of the organizations. Similarly, if structured by the dominant players in the sector—that is, the near monopolistic large nonprofits—self-regulation standards can be used as barriers to entry against small organizations or new groups that may be considered prospective or actual competitors.

> The voluntary nature of self-regulation is a central weakness. If it's voluntary, an organization can opt out or simply refuse to sign on, though opting out can have substantial consequences.

> To be effective, self-regulation must be matched with publicity. Consumers—or in this case, the nonprofits and their stakeholders and communities—must have sufficient information about the self-regulatory standards and mechanisms and their primacy in the sector, or they become no more than a link on a Web page.

> The public must be able to see the consequences of enforcement, that self-regulation has actual consequences. Because there is scant evidence of major trade associations—nonprofit or for-profit—ejecting their scandal-ridden members, the public has little confidence in the efficacy of self-regulation.

> Self-regulation seems to have functioned best where the market has been a driver, where consumers can shift their patronage to organizations that meet promulgated standards. For example, home buyers want reputable real estate brokers and turn to the National Association of Realtors as a powerful arbiter. Such market pressure has made the association use high standards to shore up levels of trust. For nonprofits, the effect of market-driven standards is less clear, but for foundations, it is difficult to imagine philanthropic grantseekers, the consumers, not submitting proposals to foundations that don't rank as high as others.

> Similarly, strong, credible professional organizations are needed that can withstand challenge and criticism. Few organizations possess the courage to make public allegations about malefactors. Partly, they fear retribution—threats from organizations and individuals or even litigation for libel or slander. Partly, they fear the effect on fundraising, the concern that bad press for the sector will hurt their own fundraising. As a result, although the press will name names, most of the nonprofit trade associations will only obliquely refer to unnamed "bad apples."

Limited self-regulation works when consumers and the regulated organizations change their behavior based on the information generated by compliance or noncompliance. An example is the behavior of donors, who can direct their charitable giving to nonprofits that garner good ratings from BBB Wise Giving or Charity Navigator, and away from the organizations falling short. Organizations that want to maintain their reputations for reliability and performance would in theory alter their policies and practices to correct areas where they fall short. Unfortunately, as some have noted, information on nonprofit effectiveness and efficiency has, to date, had little demonstrable effect on the giving decisions of individual or institutional donors.[10]

Constructing effective self-regulation: If the sector can overcome its fear of government, it has the chance of devising complementary mechanisms of self-governance that strengthen oversight and enforcement. Make no mistake: Self-regulation is only one leg of the stool. Effective nonprofit accountability requires strengthened federal and state laws, regulations, and enforcement; the third leg is an infusion of resources to make self-regulation and government regulation work. Unlike the portrait of Dorian Gray, the nonprofit sector won't crumble and die if it takes a hard look in the mirror, joined by government regulators, to clean up and clean out the problem areas. To make self-regulation functional, the following lessons are worth learning:

> Tools in the toolbox: Think of self-regulation as one of the tools in the accountability toolbox. Some aspects of self-regulation work well; others don't. The challenge is figuring out which pieces of self-regulation fit the task at hand. The regulatory tools, whether self-regulatory schemes or government oversight, have to be targeted to the elements of nonprofit behavior that they fit, and they have to be proportional to the scope of the problems addressed.

> Small isn't necessarily beautiful: No one should fall prey to the "small is beautiful" argument that small nonprofits should be exempted from oversight and regulation. Further, the sector should neither permit the large nonprofits to set the rules for their own benefit nor hide behind the skirts of smaller nonprofits decrying the burdens of excessive regulation. Although the nonprofit sector's leadership seems to prefer blue-ribbon efforts that are dominated by "distinguished CEOs" of mega-nonprofits, a process for generating standards of accountability that is more democratic and transparent might be a way of ensuring that the sector's oligopolies don't end up writing the rules.

> Noncompliance measures: Proponents of self-regulation intimate that self-regulation is a matter of self-actualizing willpower, internalized by probity-focused individuals within nonprofit organizations. Rarely do any of the proponents of self-regulatory schemes spell out how they will convincingly address noncompliance. Punishing the accountability scofflaws and making the noncompliance regimes public are crucial components of self-regulatory success. For the most part, the nonprofit sector is polite and collegial, searching

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for consensus. Effective regulation, however, requires the less-than-polite behavior of pointing a finger at miscreants and saying "you've crossed the line" or even "get out."

> Widespread support: If "voluntary" self-regulation functions with limited support throughout the sector, with players able to opt in and out with little consequence, the public will find little confidence in self-regulation.

> Credibility of the self-regulators: The sources at the beginning of this paper contrasted the sector's intellectual capabilities with the lack of knowledge and experience of the government regulators they opposed and feared. If the nonprofit sector claims that the IRS, for example, lacks a track record that inspires trust and credibility, the same goes for the self-regulatory bodies within the nonprofit sector itself. Notwithstanding the many good people in the membership of the COF, many nonprofits might view COF's oversight of foundation accountability as the foxes in charge of security at the henhouse. The ancient Romans had a phrase for it, "*Quis custodiet ipsos custodies?*" or "Who guards the guardians?" Show us the foundations whose membership dues have been spurned, or better, refunded by the council because of failure to live up to foundation accountability principles, and that will be a step toward self-regulatory credibility.

A *Wall Street Journal* editorial not long ago weighed in against government regulation of nonprofits.[11] Timed with the concerted corporate accountability reflex against Sarbanes-Oxley, the *Journal* shuddered at the thought of the three dozen recommendations on nonprofit oversight in the Senate Finance Committee's white paper and proffered the alternative of self-regulation modeled on ECFA's Christian nonprofit standards and the Maryland Association of Nonprofit Organizations' (MANO) "seal of excellence." The *Journal* concluded its self-regulatory plea with a holiday season wish: "In the spirit of the season, we urge Mr. Grassley to give our armies of compassion a chance to prove themselves anew."

When it comes to effective self-regulation and oversight in the era that started roughly a decade ago with the disgraces of the United Way's William Aramony, the sector has to do more than the ECFA and MANO approaches. In the wake of Enron and Tyco, critical observers of corporate behavior realize that self-regulation and more punitive government regulation are complementary, not alternatives. The great case in point is the not-for-profit New York Stock Exchange (NYSE), a self-described instrument of self-regulation whose compliance with even minimal procedural requirements was undermined when it came to former Chief Executive Officer Richard Grasso's salary and by the NYSE Foundation's increasing grantmaking generosity to charities associated with the NYSE board members charged with reviewing Grasso's $140 million compensation.[12] It took New York Attorney General Spitzer's intervention to slap some sense into the out-of-control self-regulating NYSE.

The NYSE's self-regulation, like the pre-Enron self-regulation among accounting firms, is really interest promotion masquerading as self-regulation. Like the historically delusional who cite the pre-Enron accounting industry as a success story in self-regulation, observers who encourage nonprofits toward self-regulation with the adage "physician, heal thyself"[13] obviously fail to see the irony in citing the notoriously regulation-defensive medical industry. Wrapping themselves in the angel wings of accountability through self-regulation, the nonprofit sector's leadership organizations will do little to advance accountability until they put teeth to their own self-regulatory efforts and get over their fear of complementary government oversight and enforcement.

Notes

1. Les Silverman, "Building Better Foundations," in *The McKinsey Quarterly* (2004: Number 1, http://www.mckinseyquarterly.com/article_page.aspx?ar=1382&L2=33&L3=95).
2. The 145 reviews include not only private foundations (filing 990-PFs) but also split-interest charitable trusts (form 5227), other charitable trust accumulations (form 1041A), and the returns of revoked private foundations (form 1120).
3. In comparison, in 1997, when there were significantly fewer private foundations and other nonprofits, the IRS reviewed or audited 503 tax exempts filing 990-PFs and other charitable trusts plus 4,168 tax-exempt organizations filing 990s and 990EZs.
4. The recently announced IRS reviews of the NAACP and 59 other nonprofits for their political speech constitute a politicized and potentially dangerous use of the IRS that extends far beyond the accountability issues being debated in the sector.
5. Representing the National Association of State Charity Officials, Mark Pacella testified on June 22, 2004, to the Senate Finance Committee that less than half of the states are regular participants in NASCO and most states "do not have personnel dedicated to the exclusive regulation of charities."

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