



Regulating Foundations: A Delicate Balance

Executive Vice President–COO's Report
2004 ANNUAL REPORT



MISSION STATEMENT

The Commonwealth Fund is a private foundation established in 1918 by Anna M. Harkness with the broad charge to enhance the common good. The Fund carries out this mandate by supporting efforts that help people live healthy and productive lives and by assisting specific groups with serious and neglected problems. The Fund supports independent research on health and social issues and makes grants to improve health care practice and policy.

The Fund's two national program areas are improving health insurance coverage and access to care and improving the quality of health care services. The Fund is dedicated to helping people become more informed about their health care and to improving care for vulnerable populations, such as children, elderly people, low income families, minority Americans, and the uninsured. An international program in health policy is designed to stimulate innovative policies and practices in the United States and other industrialized countries. In its own community, New York City, the Fund also makes grants to improve health care.

About the cover

The Commonwealth Fund board of directors is responsible for the foundation's governance. A policy-setting board, its members serve on Executive and Finance, Audit and Compliance, Governance and Nominating, and Investment committees whose work ensures strong oversight of the institution's management, program strategies, and endowment. Members include William R. Brody, M.D., president of Johns Hopkins University; Robert C. Pozen, chairman of MFS Investment Management; and Jane E. Henney, M.D., senior vice president and provost for health affairs at the University of Cincinnati.



John E. Craig, Jr.

Executive Vice President–COO’s Report

Regulating Foundations: A Delicate Balance

JOHN E. CRAIG, JR.
The Commonwealth Fund

Foundations have been the subject of much scrutiny over the last year on Capitol Hill, in the offices of state attorneys general, and in the media. Amidst numerous calls for increased regulation of the sector, leaders of the foundation community have attempted to respond to the challenges posed. Yet, so far, relatively little of the attention has focused on the positive role most foundations play in society—and how to avoid damage to strongly performing institutions while ensuring accountability throughout the sector. Many people, both inside and outside philanthropy, believe that a closer, more comprehensive, and much more thoughtful examination of the regulatory structure governing foundations is warranted.

THE CHALLENGE: FOUNDATIONS UNDER HEIGHTENED SCRUTINY

Many forces account for the increased scrutiny foundations are encountering today. These include the well-documented misbehavior of some

nonprofits and private foundations;¹ inadequate understanding of the varying operating practices of private foundations; heightened attention to the accountability of all governing boards following the Enron and other corporate scandals; preference in some quarters for higher foundation spending rates to meet immediate social and cultural needs; and dissatisfaction of some observers with the programs foundations choose to sponsor.

Those factors contributed to the 2003 passage of the Charitable Giving Act (H.R. 7) by the House of Representatives. As originally drafted, the bill would have prohibited foundations from counting most intramural spending toward their federally required annual payout. Such a change would have substantially increased the payout requirement for many foundations, leading to major erosion in the purchasing power of their endowments over the next 20 years.

Prior to the bill’s passage, however, the House leadership worked closely with foundation

representatives to rethink the handling of internal expenses. Reflecting the compromise reached, the version passed by the House in September 2003 permitted the allocation of certain internal expenses and the administrative costs associated with them—for research, program development, and communications, for example—toward the payout requirement. The Senate and House were ultimately unable to reconcile their respective legislation on charitable giving in 2003, and the bill did not become law. Nevertheless, the compromise was an important step toward better congressional understanding of foundations and the nature of their work.

In 2004, the Senate Finance Committee (SFC) returned to the issue of nonprofit and foundation governance. In anticipation of a new round of legislation, committee staff produced a discussion draft, which served as the basis for hearings held on June 22, 2004, and a follow-up Charitable Governance Roundtable.

The SFC discussion draft proposed an unprecedented role for the federal government in the management and regulation of the nonprofit and philanthropic sector. Its provisions included:

- review of each organization's tax-exempt status every five years, with voluminous filing requirements;
- defining as an "administrative expense" any foundation expenditure that is not an extramural grant;
- detailed review of intramural expenses greater than 10 percent of a foundation's total expenses, with determination by the Internal Revenue Service (IRS) of the appropriateness of counting those expenses toward the required annual payout;
- disallowance of any intramural spending

- greater than 35 percent of the total as part of the qualifying distribution for meeting the annual payout requirement;
- for highly paid managers, substantial documentation and public disclosure of information regarding compensation;
- limits on expenses for travel, meals, and accommodation;
- incentives for foundations to increase their payout to 12 percent, from the current minimum of 5 percent;
- detailed requirements for institutional oversight and management by boards of directors, with confirmation of compliance provided on organizations' IRS tax returns (the 990 for nonprofits, and the 990-PF for private foundations);
- a requirement that all organizations change their auditors every five years;
- a requirement that boards of directors have no fewer than three members, and no more than 15;
- IRS authority to remove, with cause, any board member of an organization;
- prohibition or severe limits on compensation of foundation trustees;
- publication on an organization's Web site of all documents required to be filed with regulators;
- additional fees to be paid to the IRS for numerous new required filings;
- federal support of accrediting agencies for charities and subgroups, such as foundations, with accreditation fees to be paid by organizations and the IRS able to base charitable status on accreditation; and
- a requirement that tax returns for organizations include detailed descriptions of annual performance goals and measures.

Many of the governance measures contemplated in the SFC draft originated in the Sarbanes–Oxley Act of 2002, which concerned corporate accountability. Some measures, however, go well beyond those required even in the corporate context—for example, the proposal that organizations change their independent auditors at least every five years.

Some measures proposed in the discussion draft, especially those intended to address problematic areas like inappropriate tax shelters, were favorably received at the June 22 hearings. Yet the broader proposals to expand federal involvement in the activities of nonprofits and private foundations were severely criticized, both then and in subsequent discourse, as too intrusive and micromanaging, unmindful of the regulatory burdens already borne by nonprofit organizations, inadequately appreciative of the diligence exercised by most nonprofit boards, and underestimating the merits of self-regulation in a heterogeneous and overwhelmingly public-spirited sector. For example:

- Most of the information to be submitted by foundations for five-year reviews of their tax-exempt status is already submitted in annual IRS tax returns. Moreover, the IRS clearly lacks the resources to review five-year filings from the nearly 1.4 million nonprofit organizations in the United States.
- Attempting to codify in detail the responsibilities of nonprofit boards underestimates the responsible behavior of the great majority of nonprofit boards. Doing so could also undermine their effectiveness by concentrating efforts on code requirements instead of the broader needs of the organization, and would almost certainly discourage board service by able individuals,

given the increased liability concerns arising from detailed codification of responsibilities.

- Mandated five-year terms for auditors of all organizations regardless of size, purpose, or geographic setting ignores the importance of continuity and experience in the auditing exercise. Such a limit would be especially burdensome for small organizations in localities with a limited number of qualified auditors.
- The proposed maximum of 15 board members for an organization does not take into account the need of universities, hospitals, and other large organizations for larger boards with a wide range of competencies, which are exercised through board committee structures.
- Federally sponsored accrediting agencies pose the risk of political influence in the missions and management of nonprofits.

Finance Committee Chairman Senator Charles Grassley has indicated the need for caution regarding comprehensive legislation and has stated that any legislation in the near term will likely focus on tackling specific abuses. The outcome of ongoing activity by the committee remains uncertain, however, and the issues at stake for foundations and nonprofits generally are momentous.

Foundations have also received attention from state officials. Incorporated under state law, foundations are held accountable by states for certain standards of behavior.² Using the Sarbanes–Oxley legislation as their springboard, attorneys general in several states—including California, Connecticut, Hawaii, Massachusetts, and New York—have introduced legislation that would tighten state regulation of the nonprofit and foundation sectors. With varying degrees of success,

nonprofit organizations in each of those states have worked to help ensure that any new legislation promotes best practices by governing boards, while neither undermining the ability of nonprofits to attract able board members nor adding burdensome new regulations.

Foundations have also been the subject of considerable negative press recently. Major newspapers, the *Boston Globe* in particular, have devoted substantial coverage to questionable practices in the nonprofit sector, including foundations. Although the *Wall Street Journal* ran an insightful story on how health care foundations like The Commonwealth Fund are stimulating quality improvement in health care—and the media sometimes report the results of foundation programs—the focus of the press has generally been on foundations' expenses, particularly trustee and executive compensation, and examples of misconduct.

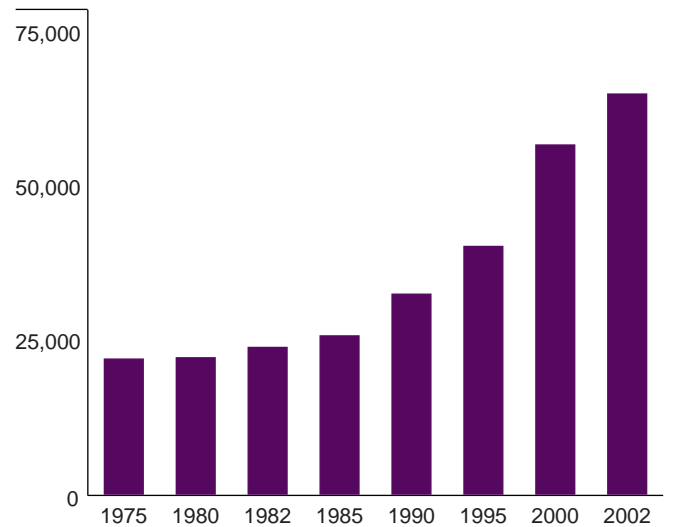
THE FACTS: A CHANGING FOUNDATION SECTOR

The oversight and watchdog functions performed by Congress, the IRS, offices of state attorneys general, and the media are beneficial, in that they can lead to corrective action in cases of real misbehavior. Their effectiveness is weakened, however, by misperceptions or inadequate understanding of key aspects of the foundation sector: its recent growth, its structure and heterogeneity, the operating styles of different foundations, and information available on foundations' activities.

Recent Dynamic Growth

The economic stagflation of the 1970s, combined with 1969 federal regulations that established disincentives for the formation of foundations and mandated annual payout rates exceeding market

The number of foundations grew by 173 percent between 1982 and 2002.

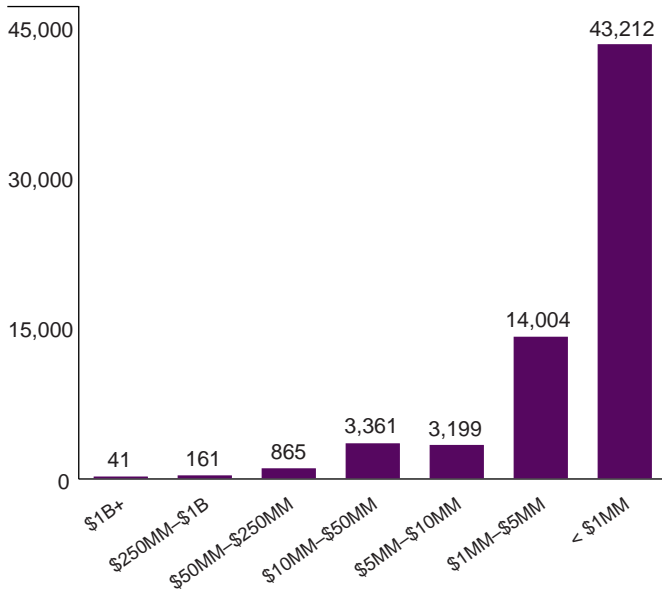


The Foundation Center, 2003.

returns, produced an essentially stagnant foundation sector. As a result, the number of organizations remained stable at roughly 22,000 from 1975 until 1980. The long bull stock market of 1982–2000, the large number of new fortunes created in the same period by the technology revolution and economic growth, and a more favorable federal regulatory environment from 1980 onward produced a major new wave of foundation formation: the number of foundations grew from 23,770 in 1982 to nearly 65,000 in 2002. Today, almost half of foundations with assets of \$1 million or more were formed after 1989 (more than 10,000 institutions).

Two features of the recent growth in the foundation sector have significant implications for an appropriate regulatory apparatus for the sector. First, foundation formation is no longer the preserve of the super-rich, as it largely was in earlier eras. Foundations are now established by individuals of comparatively modest wealth, with a resulting

Only 202 foundations have assets of \$250 million or more, while 43,212 have assets of less than \$1 million.



The Foundation Center, 2003.

explosion in the number of foundations with assets under \$5 million, and even \$1 million.

Second, even as the sector has been “democratized” with respect to the relative wealth of founders, it has also become far more diversified geographically. The share of foundations in the Northeast, for example, fell from 38 percent in 1982 to 31 percent in 2002, and the Midwest, from 27 percent to 25 percent, while the share in the South rose from 22 percent to 26 percent, and the West, from 13 percent to 17 percent. Among the seven states with the most foundations, Florida replaced Massachusetts between 1980 and 2002, joining New York, California, Illinois, Texas, Pennsylvania, and Ohio. Even within the seven states accounting for 50 percent of all foundations, growth differentials over the 22-year period were marked: California’s growth rate was highest, at 226 percent, and New York’s was lowest, at 91 percent.

A “Small Firm” Sector

A peculiar feature of the foundation sector is the extent to which assets are concentrated in a small group of institutions: 41 foundations with assets exceeding \$1 billion account for 32 percent of all foundation wealth, and 161 foundations with assets between \$250 million and \$1 billion account for another 17 percent.

By contrast, small foundations (those with assets between \$1 million and \$5 million) and very small organizations (with assets less than \$1 million) hold only 7 percent and 3 percent, respectively, of the sector’s wealth. They are, however, extremely numerous. Small foundations number 14,004, and very small foundations, 43,212. The average endowment assets of small foundations is \$2.2 million and of very small foundations \$270,000. The high annual payout rates of these foundations (14 percent and 28 percent, respectively) reflects the fact that many of them are “pass-through” entities used as charitable giving conduits in the donor’s lifetime. Some of these small institutions are destined to become very large as the result of donor bequests, but the very limited number of foundations currently with assets of \$250 million or more indicates that most small and very small foundations will remain so.

A Range of Operating Styles

The earliest foundations, including The Commonwealth Fund, have pursued a “value-added” style of grantmaking. From the beginning, they employed professional staffs charged with the responsibility for developing grantmaking strategies, working with grantees to develop projects, monitoring the progress of grantees’ work, taking corrective action when needed, and disseminating the results of the work of grantees. Value-added foundations have also mounted their own intramural

research programs and taken responsibility for managing programs or projects directly when skilled external grantees were not available, or when direct management by the foundation was expected to be a more productive strategy. Run essentially as nonprofit businesses, value-added foundations have enhanced the impact of their programs by connecting grantees with each other to build synergies among projects. In addition, they have created opportunities for grantees to present their work to influential audiences, and developed communications programs whose activities include co-authoring papers with grantees, operating sophisticated Web sites, and testifying before Congress. Not surprisingly, foundations with a value-added operating style have also emphasized the assessment of performance relative to goals, not only for grantees but for their own work.

The value-added approach of the early foundations, with its many requirements and pressures, proved more challenging than most donors were willing or could afford to attempt. As a result, for many years the great majority of foundations operated purely as grantmakers, focusing on basic due diligence with regard to proposals and the work of grantees. In contrast with value-added foundations, these “low-engagement” foundations do not need substantial intramural staff and therefore have low internal operating budgets.

Over the last 25 years, however, a growing number of foundations—particularly large, newer ones—have chosen to adopt the value-added model. In fields such as health care, they have been stimulated to do so by the example of established institutions like The Commonwealth Fund, which provide evidence that devoting substantial resources to intramural activities over an extended period pays off handsomely in terms of the productivity of grantees

and the foundation’s overall performance.³ Other circumstances contributing to the return to favor of the high-engagement, value-added model are the proclivities of entrepreneurial founders, who tend to apply to their philanthropic efforts the same energy and hands-on direction that made them successful in creating major new businesses. Additionally, a growing body of literature by researchers such as Michael E. Porter at Harvard Business School supports the pursuit of value-added strategies.⁴

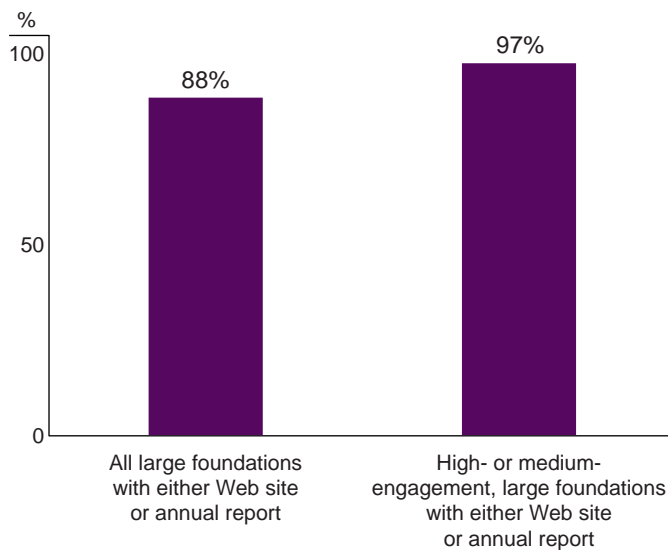
Thus, the operating styles of private foundations today range along a spectrum from low engagement to high engagement. An understanding of a foundation’s operating style is essential for understanding its spending practices.⁵ Regrettably, few observers outside the field seem to appreciate this, with the result that some observers label all intramural spending as questionable, while the press often describes intramural outlays by foundations as “expenditures on themselves.”

Extensive Reporting of Information

Among the ironies of the proposals for increased regulation is the call for more information from foundations, a group of institutions that already voluntarily supplies a great deal of information or is required to do so by existing regulations. Foundations currently use several mechanisms to report on their activities:

- All private foundations must file annually the IRS 990-PF tax return, which in addition to soliciting data on revenues, expenses, assets, and regulatory issues also requires detailed information on grants, programs, and endowment investments. The inadequacies of the 990-PF as an information source and regulatory device are discussed below, but the huge volume of information it solicits is

The great majority of foundations with \$250 million or more in assets maintain Web sites and publish annual reports that provide a great deal of information on their activities.



The Commonwealth Fund 2004 Survey of Large Foundation Web Sites.

nonetheless available to all—since 2000 on Guidestar.com, in the offices of the Foundation Center, or from the foundations themselves.

- The Foundation Center, supported principally with grants from foundations and with regional offices and collections around the country, collects data on all foundations; maintains a searchable Internet database on all known grantmakers (including private, community, corporate, and operating foundations); publishes reports tracking foundation trends; maintains a user-friendly Web site designed to assist would-be grantees, researchers, and regulators; and provides training on the use of its services.
- Most large and many smaller foundations publish annual reports or, increasingly,

maintain Web sites designed to communicate their purposes and giving strategies and disseminate the results of their work. Of the top 200 private foundations (accounting for 45 percent of all foundation assets) in 2002, for example, 88 percent either published a detailed annual report or maintained a Web site disclosing a substantial amount of information on their activities. This percentage rises to 97 percent when low-engagement foundations that devote their resources to a few local or regional institutions are omitted.

- Most state attorneys general require annual submission of reports from foundations.

THE REGULATORY DILEMMA

This sketch of the foundation sector gives some indication of the challenge facing regulators and watchdogs in monitoring foundations' activities and identifying misconduct. Those with oversight responsibilities face a rapidly growing, highly diverse, and dynamic sector whose modes of operation are changing in response to societal needs.

The distribution of foundation assets poses a particular problem for regulators and anyone seeking to monitor the activities of the sector. Large foundations—few in number—are relatively easy to monitor and can afford, within reason, the resources needed to comply with regulatory requirements for information and pursue best practices. Further, the size of these institutions and the number of internal and external stakeholders in their affairs promote an institutional ethic of accountability. Because of these factors and the visibility of foundations, instances of misconduct tend to be self-corrected quickly. Not surprisingly, a 1984 IRS study of large foundations found this segment of the sector to be well run—

a finding that weighed significantly in the IRS's decision to devote fewer resources to oversight of the sector.

But small foundations—extremely large in number—are much more difficult to track. As a group, small and very small foundations are the organizations that warrant particular attention because of the recent formation of many, their limited visibility and scarcity of stakeholders in their affairs, their varying knowledge of and ability to implement best practices, and the heterogeneity of their purposes and missions. Paradoxically, small foundations are also least able to afford significant regulatory burdens, particularly when the opportunity cost of such burdens is taken into account.

Monitoring the activities of some 57,000 small and very small foundations is made all the more difficult by the paucity of regulatory resources. When the 2 percent excise tax on foundations' net investment income was enacted in 1969, experts advised that a substantial portion of the revenues raised be dedicated to funding regulation of the sector by the IRS. That step was not taken, with the result that the IRS lacks the capacity to perform the oversight function most observers regard as necessary. Further, the nonprofit nature of the foundation sector, and the likely concentration of misconduct in small and very small institutions, results in comparatively little financial payoff from time spent by field agents in the sector.⁶

State attorneys general have a wide range of responsibilities, and the resources available to them are stretched very thin. Few have the capacity to analyze the voluminous reports submitted to them by foundations each year, with the result that virtually all rely on “whistleblower” reports from individuals or the media as a trigger for looking into

a foundation's affairs. Regulatory shortcomings are further compounded by confidentiality considerations, which by law prevent the routine sharing between the IRS and state attorneys generals of much information on foundations.

Perhaps the greatest obstacle to appropriate regulation of the foundation sector, however, is the 990-PF itself—the primary instrument used by the IRS to collect information on foundations, and one on which state attorneys general, the media, and researchers rely. The faults of the 990-PF can be summarized as follows:

- Little altered in format since at least 1969, its underlying premise is that most foundations are exclusively grantmakers, when in fact foundations have become increasingly diverse in their operating styles. The bifurcation of expense data requested on the 990-PF between “Operating and Administrative Expenses” and “Contributions, Gifts, Grants Paid” encourages the presumption that all intramural expenses are for general administration, when for high- and medium-engagement foundations this is unlikely to be the case.
- Because of the detailed information requested on foundations' endowment assets and investment activity (purchases and sales), the 990-PF return for a foundation like The Commonwealth Fund is typically 500 to 600 pages in length. Most of the information requested on individual investments and thousands of financial transactions is unmanageable and of little use for regulatory purposes. Yet the mass of information solicited poses a major obstacle to electronic submission of the return and electronic analyses of this potentially important database.

- Most data collected on foundations' revenues and expenses and assets/liabilities are geared to the calculation of the required qualifying distribution and annual excise tax—not to presenting a picture of the foundation's expense structure in the context of its operating style, nor to shedding light on the investment performance of its endowment. As a result, the presentation of the data on the 990-PF is, at best, confusing to researchers and the media and, at worst, misleading.
- The 990-PF lacks clear definitions of the categories of expenses that foundations are required to report; consequently, considerable inconsistency arises as foundations attempt to interpret IRS instructions and classify their expenditures.
- The relevance in the foundation context of a fair amount of information collected on the 990-PF is questionable—for example, interest expense, inventories for sale or use, and mortgage loan investments as an assets category.
- Information on potentially controversial areas, such as trustee compensation, is not solicited in formats that make it readily identifiable.

Given all these faults, databases constructed from the 990-PF are seriously flawed, as are many of the analyses that regulators, researchers, and the media base on them.

TOWARD MORE EFFECTIVE REGULATION OF THE FOUNDATION SECTOR

A number of steps could be taken to improve the federal government's oversight of the foundation sector and make the regulatory process more modern, simple, and efficient.

A Major Overhaul of the 990-PF

The Foundation Financial Officers Group (FFOG), an association of the chief financial officers of a wide range of foundations, including most large entities, is currently testing a proposed new set of Financial Reporting Standards, with the hope that those standards might ultimately be incorporated into a revised 990-PF.

The major innovation of the FFOG proposal would be to ask foundations to allocate their expenses across four categories:

- Direct Public Benefit Activities, including external grants and programs directly operated by the foundation, such as fellowships, intramural research and evaluation, communications, grantee forums and joint work with grantees, technical assistance to governmental bodies, social services, arts performances, historic preservation, museums, and other programs with significance beyond the foundation's grants programs;
- Grantmaking Activities, including resources dedicated to selecting grantees, monitoring the progress of projects, evaluating programs, and meeting regulatory requirements regarding grants;
- General and Administrative Activities, including the overall operation of the foundation and work not directly connected to any of the other three categories; and
- Investment Management Activities, representing the costs of internal investment staff and other expenses associated with management of the foundation's endowment.

In addition to providing helpful guidelines for those allocations, the FFOG proposal would also define expense elements more clearly than does the

current 990-PF, make needed corrections in requested expense elements, and ask foundations to identify their operating style as low engagement, medium engagement, or high engagement.

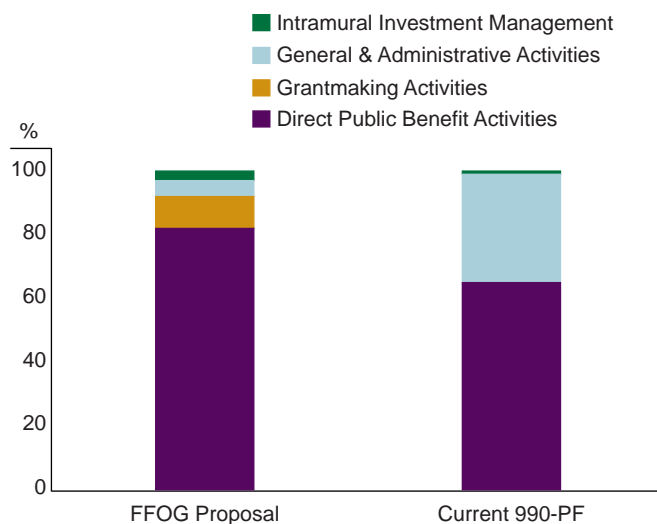
A recent test of the proposed FFOG format by 34 foundations, including The Commonwealth Fund, indicates that this innovation provides a much clearer, more accurate picture of how foundations allocate resources to accomplish their missions than does the existing 990-PF format (see adjacent figure).⁷ It is to be hoped that, after a period of testing, the IRS will move rapidly to adopt this modernized approach to data collection.

As suggested by Betsy Buchalter Adler, chair of the Exempt Organizations Committee of the American Bar Association's Section of Taxation, a redesigned 990-PF could also address, in question form, most of the governance and management concerns raised by the recent SFC discussion draft. Questions could easily cover such topics as whether or not a foundation has a conflict-of-interest policy (and if not, why not), internal governance practices, and a process for determining executive compensation. This approach would put pressure on institutions to develop appropriate policies and implement best practices. It would also help the IRS and state attorneys general to target their audit resources—without slipping into micromanagement of individual institutions.

Electronic Filing and Database Creation

No less important than revising the expense reporting framework would be simplifying the 990-PF to enable electronic filing. The 990 for nonprofits can already be filed electronically, and the barriers to electronic filing by foundations should be few once the unnecessary investments information requirement noted above is eliminated.⁸ Electronic

The proposed FFOG expense reporting format presents a far more accurate picture of the expenditures of value-added foundations like The Commonwealth Fund than does the current 990-PF format.



The Commonwealth Fund, 2004.

filing would greatly improve the accuracy and completeness of foundation tax returns, as electronic systems require all key data fields to be filled and check automatically for errors. Electronic filing would also promote information-sharing between regulators.

These steps would allow foundation 990-PFs to be assembled into a searchable database, which in turn would allow for the development of benchmarks for expense allocations according to foundation operating style. Benchmarks would have to be used carefully, given the heterogeneity of the sector even within operating styles, but they would be a major resource to guide the activities of regulators and watchdogs.⁹

The collection of better information through a revised 990-PF and the creation of an electronic database to make that information available would

facilitate the development of improved algorithms for targeting audits, thereby promoting better use of scarce regulatory resources.

Increased Regulatory Resources and Information-Sharing
Clearly, additional IRS resources would be needed to develop more sophisticated regulatory approaches, implement e-filing of tax returns, analyze the improved database on foundations, develop algorithms for targeting audits, and train additional field staff. At least some portion of revenues raised by the excise tax on foundations should be set aside for such purposes, with some allocation to state regulators.

Given governmental fiscal constraints and the foundation sector's commitment to improved self-regulation, a group of leading foundations would undoubtedly underwrite a public-private collaboration with the IRS to overhaul the 990-PF as outlined above. Such a group could well be the source of voluntary funding for other initiatives to improve the regulatory structure. As Marion R. Fremont-Smith observes, "with adequate funding and personnel, the Internal Revenue Service would have been able to prevent most of the abuses [the Senate Finance Committee] is addressing. It is not the code provisions that are inadequate; rather it has been the inability of the Service to adequately police the sector."¹⁰

Further, there is near-universal agreement that the IRS and state attorneys general should be encouraged to share information on foundations involved in questionable practices, and that most existing legal obstacles to such coordination should be removed. Coordination across jurisdictions would not address all the problems arising from the inadequacy of current regulatory resources, but information-sharing would help target regulatory efforts on the trouble spots.

REEXAMINING THE PLACE OF SMALL AND VERY SMALL FOUNDATIONS

Very few foundations with assets of less than \$5 million can afford the professional staff necessary to add value to the work of their grantees. There can be little justification, therefore, for substantial intramural expenses, except when the foundation is operating programs directly. At the same time, small foundations face significant challenges in handling their affairs well, including substantial startup costs, diseconomies of scale, attracting conscientious board members, and avoiding the temptations of using the foundation for nonphilanthropic ends (such as inappropriate compensation of family members). The available evidence suggests that regulators should focus their attention on this extremely large "small firm" segment of the foundation community. Yet, no amount of regulatory resources or requirements can fully address the potential for misconduct in a sector that has grown as rapidly as has the small foundation community in recent years.

Thus, the foundation community, researchers, and regulators should reexamine the rationale for encouraging the creation of foundations with assets of less than \$5 million, especially given the alternative of donor-advised funds managed by community foundations or large mutual fund companies.¹¹

THE FOUNDATION SECTOR'S RESPONSIBILITIES

Study of the foundation sector and the regulatory challenges it presents leads inescapably to the conclusion that the sector itself must take a more active role in defining best practices, encouraging their adoption, and working with individual foundations and regulators to identify and correct abuses.

This work is already under way. In 2004, the Foundation Executives Group issued *Governance*

Principles for Large Foundations (www.cof.org), thus adding to the recommended standards introduced in the Council on Foundations' 2002 *Principles and Practices for Effective Grantmaking*, and more recent *Stewardship Principles and Best Practices for Family Foundations* and *Stewardship Principles and Best Practices for Corporate Grantmakers*.

Yet publishing guidelines and books on proper stewardship and good management may not be enough. Foundation sector organizations—the Council on Foundations and regional associations of foundations—may well need to go further in their efforts to promote best practices. Foundation membership organizations should consider establishing proactive committees to which individuals concerned about particular foundations' practices might turn. Properly staffed and charged with well-defined mandates, state or regional voluntary “foundation stewardship” committees could help thwart abuses and, equally important, use information available to them as sector leaders to help regulators use their resources more efficiently—for example, by advising on the level of investigatory response appropriate to a media report of foundation abuse.

The performance of any foundation, of course, depends ultimately on the quality of its governing board, the body with legal fiduciary responsibility for its operations. Recent attention to governance issues has spurred many foundations to review their governance structure and processes and to identify and address potential weaknesses. As an example, The Commonwealth Fund's recently revised code of ethics, conflict-of-interest policy, and board committee charters are posted on the foundation's Web site.

DO NO HARM

Given the number and diversity of foundations, neither the IRS nor state regulators can hope to manage them directly. The public must rely on strong governing boards to ensure the accountability and performance of foundations. As New York State, Attorney General Eliot Spitzer has said “I think we need to educate [nonprofit boards] about what the laws require, and what their obligations are: to ask questions about financials, to inquire about salaries, to inquire about self-dealing...”¹² Yet several of the witnesses who addressed or submitted comments to the SFC at its June 2004 hearings observed that the proposed federal regulatory measures threatened to discourage board service by precisely the kind of people needed by foundations.

In his testimony before the Senate Finance Committee, Derek Bok, former president of Harvard University and now faculty chair of Harvard's Hauser Center for Non-Profit Organizations, cautioned that “there is danger that in enacting rules in response to a few particularly flagrant, widely publicized abuses, regulators will impose burdens of paperwork, record-keeping, and other costs on all nonprofits that will more than equal any benefits achieved by government intervention.”¹³

Jonathan Small, president of the Nonprofit Coordinating Committee of New York, encouraged the committee to

keep in mind as you review federal regulation of nonprofits the Hippocratic oath taken by doctors: ‘Do no harm.’ There are already many laws and regulations governing the operation of nonprofits, as well as a number of watchdog organizations monitoring

them. We believe that the vast majority of abuse and misconduct is already covered by existing rules; therefore, what is needed most is enforcement of those rules at the federal and state levels. Also, each new rule that prevents misbehavior or catches a bad actor can impose additional costs on tens of thousands of organizations that are behaving properly.¹⁴

This advice is well taken. If we in the foundation community hope to see it heeded, we need to step up our own efforts to ensure strong performance and accountability throughout the sector.

REFERENCES

- ¹ Specific areas of abuse include credit counseling organizations claiming tax exemption but actually used to market financial products; auto and similar donation programs; tax shelters; and failure to file accurate and timely tax returns (990 and 990-PF). Additionally, instances of excessive payment of board members and members of donors' families as staff, as well as apparently inappropriate reimbursement for travel and other expenses of such individuals have been identified.
- ² In fact, according to Marion R. Fremont-Smith of Harvard's Hauser Center for Nonprofit Organizations, relatively few states devote attention to this responsibility. She reported in a September/October 2004 *Foundation News & Commentary* interview that "the extent of enforcement of fiduciary duties in the states ranges from almost nonexistent in the majority to active in six or seven states."
- ³ John E. Craig, Jr., "[An Undervalued Species: Private Value-Added Foundations](#)," *The Commonwealth Fund Annual Report 2003*; John E. Craig, Jr., "[The Value-Added Foundation: Grantees' Views on the Fund's Performance](#)," *The Commonwealth Fund Annual Report, 2002*; and John E. Craig, Jr., "[The Fund's Performance as a Grantmaker](#)," *The Commonwealth Fund Annual Report 2000*.
- ⁴ Michael E. Porter and Mark R. Kramer, "Philanthropy's New Agenda: Creating Value," *Harvard Business Review*, November 1999.
- ⁵ Very large foundations, for example, are less able to pursue a full value-added "high-engagement" strategy because of the sheer volume of grants that must be made to meet the annual federal distribution requirement. Such foundations can be classified as "medium-engagement" foundations, reflecting their varied pursuit of a value-added strategy.
- ⁶ IRS veterans have observed that while an audit of a for-profit corporation almost invariably produces substantial tax revenues, audits of foundations and other nonprofits seldom produce revenues.
- ⁷ The marked differences in the two presentations of the Fund's expenses are due principally to the fact that the 990-PF encourages treatment of all non-grant expenses as "general and administration" expenses, regardless of their purpose. In the FFOG proposal, the Fund's non-grant expenses are functionally allocated as follows: those supporting intramural programs such as research and evaluation, communications, fellowships, and joint work with grantees—which are included along with external grants in the "Direct Public Benefit Activities" category; non-grant expenses arising from the development, selection, oversight, and management of grants—which are identified as a distinct legitimate business cost, "Grantmaking Activities"; and intramural endowment management and true general administration costs—which are more clearly defined under the FFOG format than under the current 990-PF.
- ⁸ The motivation for collecting detailed information on foundations' investments originated in concerns about diversification. Those concerns can be addressed more usefully with a simple reporting format that asks foundations to show the allocation of their endowment portfolios across major asset classes, the rank-order share of the endowment in the largest 10 positions, and, if that share is greater than a threshold (such as 20 percent), an explanation for it. Foundations should be prepared to defend the calculation of their annual net investment income and the excise tax payable on it, but the vast underlying detail should be provided on an as-needed basis.

⁹ FFOG and regulators need to give further attention to the development of metrics for identifying foundations' operating styles (low-, medium-, or high-engagement), rather than relying solely on self-declaration by each foundation.

¹⁰ Paper submitted for the July 22, 2004, Roundtable on Charitable Governance, following the June 22, 2004, hearing "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities," before the United States Senate Committee on Finance.

¹¹ Many small foundations are established as the precursor to large bequests on the death of the donor. It should be possible to continue to allow the creation of such entities, provided there is adequate evidence of a clear, long-term plan for funding a sizeable endowment of, say, \$10 million or more.

A donor-advised fund is a separately identified account maintained and operated by a community foundation, a charitable gifts division of a mutual fund company, or nonprofits such as educational, social service, health care, cultural, or religious organizations. While the donor may advise on the distribution of funds from the account and the investing of its assets, the manager must be free to accept or reject the donor's recommendations. Donor-

advised funds now number over 81,000, reflecting the tax advantages they have over private foundations, their lower cost and ease of establishment compared to foundations, and their lack of regulation. The SFC discussion draft cited the potential for abuses of donor-advised funds, such as the absence of annual payout and activity requirements, grants producing a private benefit to the donor, tax deductions for gifts of illiquid property (e.g., real estate or stock in privately held companies) producing little or no income for charitable distribution, and the valuation of such gifts. The leadership of the community foundation and mutual fund communities are working with legislators toward appropriate regulation of these vehicles.

¹² *The Legislative Gazette*, November 22, 2004 (Matt Peppe reporting on Attorney General Spitzer's interview with radio station WAMC).

¹³ Testimony by Derek Bok at the June 22, 2004, hearing "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities," before the United States Senate Committee on Finance.

¹⁴ Jonathan A. Small, Nonprofit Coordinating Committee of New York, Inc., "Comments on Senate Finance Committee Staff Discussion Draft Concerning Tax-Exempt Organizations," July 14, 2004.



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