

2013 Columbia Law School Charities Regulation and Oversight Project
Policy Conference on
"The Future of State Charities Regulation"

Mapping The Trajectory: The Changing Role Of The State Regulators

The Case For A Renewal Of Civic Capitalism In The Independent Sector

*Scott Harshbarger**

I. THE VITAL ROLE OF THE SECTOR AND THE CHALLENGE

Today, the independent, non-profit sector, founded, created and praised, as the complement or supplement to the dominant major public and private sectors of our democracy and economy, has become a major player, if not the major one, in many aspects of our social, corporate and public life. The reality in fact is that we need and depend on this sector far more than ever before. The Third Sector is now central to, and virtually the dominant player in, the charitable *and* the social justice safety net, not merely the supplement to it, because of the decline in the role of government, the increase in the role of the private sector, and the dramatic expansion of the reach/role and functions of the non-profit world in the USA. NFP entities now increasingly play and fulfill the functions of both the private and public sectors in, for example, health care, education and human services, international economic, public health, and civic stabilization, credit financing and legal services, in addition to the arts, sciences, research, and entrepreneurial and innovative risk taking pilot and other projects. The NFP sector touches all of our lives, and is vital to our quality of life. This happened, in large measure, because of tax laws that permit a huge shielding of wealth, creation of private foundations, and the influential impact of corporate social responsibility. With great opportunity and great power also comes great responsibility – in the words of Spiderman, to whom much is given, much is expected. The intersection of power and money without independent checks and balances yields corruption. It is precisely because the sector plays such a major role in American society and is the recipient of hundreds of billions of dollars in public, charitable and tax exempt funds that overarching and effective oversight of nonprofits is sorely needed. Therefore, I challenge all of us in this sector (institutions, boards, executives, and regulators) to justify, as a matter of public policy, why this sector should be immune from public accountability and responsibility.

II. THE GOVERNANCE CRISIS IN THE SECTOR

* Senior Counsel, Proskauer Rose LLP; Fmr. Massachusetts Attorney General

The examples can be ripped from the headlines – Penn State’s Integrity; Politics and the Race for the Cure; Non-profits/community groups as created to feather the nest of NY State elected officials; Major Halfway House Provider to two states as major contributors to Governor's campaigns; the executive compensation of the CEO of the once a year Fiesta Bowl; C3 and C4 Super-PACS; the disintegration of ACORN; plus the Smithsonian, United Way, and Red Cross. These are just a few examples of the reputational impact of allegedly major scandals involving flawed Non-Profit Board and Executive governance and potential abuse of state and federal charitable status, not by small, grass roots organizations, trade solicitors, or fraudulent scams. These involve nationally known, well-financed, public, private, charitable non-profits who have or could have had sophisticated boards, expert legal counsel, and are major employers and recipients of significant public and donor dollars. These flagrant, recent and recurring examples occurred in spite of the sector’s commitment, repeatedly expressed to Congress, that the sector has effective self-regulatory best practice standards; in spite of the existence of a plethora of non-profit governance experts in every sector and state; and in spite of the external enforcement and regulatory existence and oversight of Attorneys General, the Internal Revenue Service and Department of Justice, not to mention boards presumably dedicated to the highest standards of fiduciary duty!

Unfortunately, these flawed governance examples cannot merely be dismissed as exceptions or outliers – they represent the persistent and consistent reality that failed and flawed governance, oversight and regulation are far too frequent in the so-called Independent Sector.

In spite of the sector’s critical impact, status, and role in our democracy, for a variety of reasons, absent whistleblowers, media focus, partisan ideological conflicts, or elected or appointed political crusaders; this sector operates with immunity and impunity, even though it is the beneficiary of, and actively lobbies for, the highly favorable federal, state and local legal framework which supports its existence. Proposals to alter this state of affairs (let alone “mess with the charitable deduction”) face uniform and unified resistance from the sector, and regulators too often seem disinclined to alter this state, thanks to the Sector's political and civic influence, its noble mission and rhetoric, major lobbying and media power, and limited, over-stretched resources, barriers to multi-faceted coordination, and the absence of any meaningful citizen or constituency public interest advocacy groups. This role expansion, while offering immense potential, also comes with a price: First, the sector is also in the public, media, and ideological eye –and increasingly held to standards similar to corporate and public America. Second, because of the sources of financial support, and the immense sums needed to sustain the NFP place and role, the sector is often perceived to be beholden to those financial interests, donors, and their attitudes and perspectives – almost more than to its mission or constituents! It is long-overdue to ask– who then are the guardians of the public and charitable interest? And, more importantly, who, on behalf of the public interest, will lead the charge for the application of the core principles of civic capitalism to the NFP sector, as well as the public and private sectors?

III. CIVIC CAPITALISM AND THE NOT-FOR-PROFIT SECTOR

Many of us believe that effective external oversight is precisely what is needed if the nonprofit sector is to be held accountable for ensuring that the public interest in charitable giving and purposes is protected, and the public interests (not merely the sector's interests) are served, heard and valued by the Sector. Therefore, I propose that as a condition for preservation of the charitable deduction and the sector's independence, the concept of civic capitalism be used as a template for such an oversight regime, enforcement and sanctions – whether internal and/or external. The concept of civic capitalism is as relevant today to the not for profit sector, as to the corporate and public sectors. The failures we see in governance are failures of the core principles and checks and balances of democracy. Is our common good and cause our self-interest or the public interest? The concept of civic capitalism is that independence and markets are important and should generally operate freely – but only within a strong democratic framework which fosters civil society, encourages public participation, ensures accountability and regulates systemic risk.

The economic crises of the past decade unfolded because of a failure of individual and institutional accountability, a decade of lessons not learned! The obvious solution was to enact strong, but limited regulation and erect ethical barriers between the sector and regulators. The importance of an ethical corporate culture is clear but, standing alone, without a “cop on the beat,” allowed ethical breakdowns which harmed system integrity. Similarly in the NFP sector, the leaders still oppose measures to effect meaningful reforms, including more external oversight and accountability. But there is no public outrage or demand to be heard because the other missing links are a strong institutional voice and vehicle for protection of the public interest (e.g. Attorneys-General or DOJ) and citizen advocacy and participation. The remedy then is to continue to encourage and support a robust sector, engage citizens and the voices of the public, and ensures a system of governance that actively promotes board and executive accountability *and* the public's ability to provide a check.

There is merit to the argument that external regulation, or self-regulation with teeth, may have unintended consequences that might ultimately outweigh the benefits to be gained, or the benefits may be so limited that it is not worth pursuing. Yet, given the litany of abuses in the nonprofit sector and, more important, its failure to heal itself, far stronger evidence is required before it can be credibly argued that, on the merits of being the non-profit sector alone, it should be left to its own devices. The sector's institutional interests are *not* aligned in favor of civic capitalism – i.e. robust autonomy within a strong, but limited, regulatory framework where there is a real referee, a level playing field, the certainty of penalties for violations, and a belief that accountability, disclosure, independence and honest, fair governance and oversight has intrinsic systemic value.

Ironically, this "Civic Capitalism" is what we in the independent sector consistently demand – and more – from both the public and private sector that we theoretically supplement, monitor and balance! Therefore, the champions of the public interest in the Sector's constituents (including the poor, powerless and vulnerable who today, more than ever, depend upon the Sector for social and economic justice and the adherence to Democratic values) face great challenges and even greater political resistance and power from the sector in arguing that similar standards should apply, in return for the sector's “favored” status. This favored status is a result of tax laws that permit a huge amount of shielding of wealth, creation of private foundations, and the influential impact of corporate social responsibility, individual and corporate philanthropy.

The core question is whether this is still the “Independent Sector” Gardner envisioned, and, if so, on whose behalf? For example, on whose behalf does the sector – in all its diversity – unite to advocate for and preserve the charitable deduction, *but* cannot unite to aggressively lobby and advocate to preserve the social safety net, reduce gun violence, hold "Too big to fail" financial institutions accountable, reform the tax code to eliminate corporate and special interest tax breaks, or reduce the yawning and anti-democracy income inequality gap?

IV. MY "FELLOW TRAVELER" CREDENTIALS FOR MAKING THIS CHALLENGE

I make this challenge and propose these remedies, as a "fellow traveler" – the chair and vice-chair of two non-profit boards – one a major service deliverer; one an ethics excellence center; a member of not-for-profit boards for 40 years – from grassroots community councils, to public interest, legal and human services advocates and providers. I was the beneficiary of political and partnership support from a Massachusetts NFP community that pioneered de-institutionalization of care and treatment through the third sector organizations that remain today as major professional leaders. And I served as CEO of Common Cause, a major national NFP advocacy group that survived and was transformed, thanks to Foundation funding and major donor contributions.

In addition, as the Attorney General of Massachusetts and thereby the charities regulator, I oversaw this sector in all its diversity – some 33,000 of you – and learned from wise advisors and skilled practitioners. I appreciate the range and diversity, skill and expertise, and deep commitments and caring reflected by its leaders, boards and volunteers. And now, a major part of my regulatory and governance practice – and speaking and writing – is about non-profit governance, investigations, compliance and best practices, plus crisis management and, hopefully, prevention through early intervention. And I was a member of the Independent Sector Self-Regulatory Advisory group which published “Principles for Good Governance and Ethical Practices” in October, 2007.

I know and understand the legitimate concerns about potentially over-bearing, costly, bureaucratic “regulation”, having seen this now from all sides. However, these same concerns are regularly raised by the private sector as well, in spite of all evidence that they have no capacity for self regulation. Surely it is in no one’s interests – or consistent with our values – to have a major sector of our society freed from public accountability. As John Gardner noted, “Liberty, Duty; Freedom, Responsibility – that’s the deal!” Surely, absent a dramatically changed culture and investment in effective internal and self-regulation by Boards, and/or the sector peers, NFPs cannot be immune from democratic accountability.

Gardner assumed that NFP organizations of any type, and their boards and leaders, would be independent of self interest, accountable, and bound by fiduciary duties, and, therefore, free to encourage the organizations to be engaged, to be in the fray, to be the voice for those who might otherwise not be heard in society, in the halls of government or the corporate board suites, and to be their watchdogs. That was the legal basis for their freedom from government regulation and the demands of shareholder profit. And, above all, free to educate and remind citizens and government and institutions that for a government of, by and for the people, "Democracy was not a spectator sport"!

V. THE SECTOR'S MOTIVES FOR RESISTANCE TO CIVIC CAPITALISM (PUBLIC ACCOUNTABILITY) ARE SUSPECT.

There are so many lessons to be learned, and so much solid, good learning, experience and expertise within the Sector, about how NFPs can successfully and proactively apply and adapt principles of governance, accountability, independence, disclosure, compliance, oversight, fiduciary duties, codes of ethics, and standards of excellence. Therefore, the failure of the sector to champion and implement them, at least through effective forms of self-regulation, to seal off the argument for external review, raises the red flags all by itself. Ironically, these are the same kind of “flags” that many leaders in the sector use to criticize government or corporate leaders when they seek to protect secrecy, avoid disclosure, and fend off watchdogs!

Internally, just one example makes the point. Besides the extensive and effective work generally of Independent Sector's Non-Profit Panel, the attempt to devise a uniform, standardized list of “best practices” to guide nonprofit organizations, by the 2007 Panel on the Nonprofit Sector, and its Principles for Good Governance and Ethical Practice is exemplary. The report presents “33 Principles of Sound Practice,” covering Legal Compliance and Public Disclosure, Effective Governance, Strong Financial Oversight and Responsible Fundraising. These guidelines, directed to nonprofit organizations of every size and scope, are truly exceptional; they represent the best of the best practices, and the best possible check list for any nonprofit organization in terms of measuring its practices and standard.

Strides have also been made to create new, and improve upon existing, governance mechanisms designed to monitor the nonprofit industry, i.e. the IRS and its tax code and some state attorneys general, and provide limited legal, regulatory, and enforcement oversight of the nonprofit sector. The pressures of media coverage and donor demands further help to influence the direction of the industry.

Yet, Even when the record is clear that 1-2 % of the NFP organizations account for 80-90 % of the “charitable” revenue, the leading sector organizations (including trade) resist external oversight á la Sarbanes - Oxley, even in modified form, in spite of sector best practices which demonstrate effective ways to achieve excellence in governance without making it one size fits all. The sector leadership continues to defend the lowest common denominator; fails to distinguish large from small organizations, services from charity and safety net from philanthropy; and generally adheres to the code of silence in face of high profile cases of abuse – except when Congress, state and federal regulators threaten to exercise oversight in the face of patterns of abuse, or challenge the favored tax status. Just like corporate America, the sector far too often “rags the puck” to run out the clock, outlast external critics, and lobby aggressively to prevent regulation.

VI. THE REMEDY: MULTI-FACETED COLLABORATION -MANDATED!

Unless the status quo is acceptable and appropriate, and all of the forgoing discussion is deemed, "the exception proves the rule", the following actions are obvious and essential first steps in remedying the serious governance flaws that mar the sector's credibility and integrity, and which may trigger a true renewal of civic capitalism, thereby validating its 'favored' status, as a matter of good public policy.

First, the leaders of the nonprofit sector must elevate the "best practices" standards and principles from merely an aspirational resource which are valuable educational and technical assistance models for all, regardless of size, scope and function, to mandated, peer enforced minimums. They must become mandated ethical codes of governance conduct.

Second, the education and technical assistance needed to elevate Best Practices to an ethically mandatory level must be funded, preferably by foundation grants or fees initially. Without access to educational and technical assistance, self-regulation, aspirational tomes and/or external regulation will continue to be largely hollow, rhetorical, and optional. The real danger and risk of unfunded mandates is that it undermines effective enforcement and regulation.

Third, the initial level of routine enforcement and regulation should come from each of the major sector organizations and associations, which, as a condition of its existence or capacity to be an SRO, should have its own independent regulatory system, in addition to its membership, educational and best practice dissemination functions, geared to effective and efficient enforcement mechanisms for sanctioning those who violate its governance principles and best practices. Similarly, major grant making organizations should condition grants to any organization on compliance with governance principles, appropriate to their size, shape and function, and to any association which does not have an independent regulatory system.

Fourth, to insure meaningful best practices, education and SROs, and an adequate protection of the public interest, there must be a credible enforcement capacity for existing state and federal laws. Everyone concedes that the current level of state and federal funding is inadequate – if credible and consistent enforcement and regulation are required. The best models are joint federal/state task forces, or federally-funded state programs (like the Medicaid Fraud program), or federal grant-making programs (like COPS) that ensure cooperation and coordination in enforcement, but also uniformity and consistency in terms of the sectors to be regulated. Hence, a joint Department of Justice, IRS and state attorney general and/or state charitable regulator association should be established, with a sector advisory panel to meet these objectives.

At a minimum, the efforts of state AGs, through NASCO, the Columbia AG Charity Project to develop responsible, knowledgeable expertise, coordinated proactive guidelines for enforcement, build relationships with the Sector, and develop meaningful dialogue, while having the capacity to act in and for the public interest in a regulatory and enforcement role at the local level, must be encouraged and supported by the sector leaders. This would be a crucial signal of good faith, a legitimate desire to understand and influence the enforcement and regulatory priorities at the state and multi-state level. However, the enhancement of the AG role, and its maturity and consistency, cannot succeed unless these state-based public charity and public interest stewards and protectors have adequate resources. The simple solution is to support AGs charitable units being funded by a percentage of the annual state charitable filing fees, to provide AGs with adequate technology, staff, and audit and accountability capacity.

Fifth, the sector itself should have an independent inspector-general. The creation of the I-G is essential if the state and federal enforcers/regulators lack funding, and/or the SROs lack teeth. It is a useful complement, à la Owens FINRA-like proposal, if there is also a viable SRO and state/federal enforcement capacity – not duplication. If inspector-generals are useful, even if unpopular, in governmental agencies, correctional departments or private corporations, surely they are appropriate for all nonprofit sectors and activities. The details of such a proposal lay more in the question of size, scope and function and who pays and what the costs are, rather than the necessity and/or possibility of it succeeding. The inspector-generals can be funded by the major private associations in the first instance as part of the education, technical assistance and compliance budgets. As is the case with the Federal Sentencing Guidelines, this kind of compliance mechanism being in place would be viewed as a mitigating or safe harbor factor when faced with external regulators, prosecutors, or self-regulatory sanctioning.

Sixth, and maybe the most important missing remedial ingredient is the absence of strong, public advocacy, participation and engagement, whether by public agencies like the AGs, constituents, donors, independent watchdogs or experts, to ensure accountability. This is a classic element of any method of democratic accountability. This could be achieved several ways: by requiring more public accountability and fiduciary expertise of Boards ; or a cross-section of sector advisory groups for regulators; or common cause-like consumer protection “watchdogs”, à la PIRG, AARP. Drawing on the experience and success of the consumer and environmental protection and citizen advocacy movements, these groups would provide, at least in theory and potential, checks both on the regulators, and the sector guardians of fiduciary duties.

At bottom, this multi-faceted collaborative solution and remedy exposes the fundamental flaws and weaknesses of the current legal, regulatory and enforcement mechanisms, coupled with the internally-implemented best practice principles in their existing non-binding state. It demonstrates that the latter are insufficient, and likely deliberately so, to ensure a renewal of civic capitalism in the nonprofit sector. Therefore, a multi-level, multi-faceted strategy is crucial: External enforcement for crimes, fraud and fiduciary abuses at all levels; strengthened accreditation and association models, and the sanctioning requirements of grant makers; a presumptive Sarbanes-Oxley-type approach for institutions and foundations of major size and revenue; adapting core principles and methods of self-regulation with teeth at all other levels; and introducing coordinated joint federal-state oversight, plus the independent inspector-general concept of self-regulation, with citizen advocacy and participation.

This strategy is based on the belief that prevention is the best and cheapest form of protection, and that a credible, industry-specific enforcement regime can establish a framework and a minimum ethic as a boundary and floor, within which innovation, autonomy and pluralism can thrive. Such a structure would encourage the nonprofit sector to affirm its strength and mission, its belief in accountability and integrity, and its potential for doing well by doing good. It affords the industry the ability to invite and thrive on scrutiny and accountability, and to be the first to spot and solve the problems, as well as to identify and implement the remedy. By taking the lead on its own enforcement and “watchdog” regime, the sector will enhance its reputation and standing, as well as its operational efficiency and effectiveness and preserve its core values and strengths --independence, pluralism, and innovation – all to the glory and mission of strengthening our eroding civil society, common ground, common causes, and community – and our Democracy, making De Tocqueville and Gardner proud.