

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

Envisioning The Future: New Structures

Charity Oversight: An Alternative Approach

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INTRODUCTION

A number of years ago, I suggested that the time might be ripe to consider a new model for charity regulation, one modeled on the combination of self-regulation and government oversight provided to U.S. security markets by the Securities Exchange Commission ("SEC") and the National Association of Securities Dealers ("NASD") and similar self-regulatory organizations. The intervening years have not been quiet for either the charitable community or the securities industry. On the charitable side, we have seen the passage of extensive charity reform legislation in the Pension Protection Act of 2006 (the "PPA"), which, while aimed at some well-publicized and clear abuses, is written so broadly that it creates new prohibitions, administrative burdens, and legal uncertainty for many legitimate charities. In the securities industry, the SEC has considered whether the self-regulation model needs to be revisited, and the trend is toward more consolidated and more publicly accountable mechanisms for industry self-regulation, as evidenced by the structure of the Financial Industry Regulatory Authority ("FINRA"), the result of a merger of the NASD and the regulatory functions of the New York Stock Exchange ("NYSE"). Developments in both the charitable and financial sectors continue to persuade me that restructuring the federal regulation of charities along the lines of FINRA or other hybrid public/private regulators makes sense. In addition, the federal/state structure for the investigation and prosecution of Medicaid fraud, as embodied by Medicaid Fraud Control Units, suggests a model for federal/state cooperation in charities oversight.

In this paper, I expand on what a new public/private charity regulator might look like, taking into account lessons from the financial sector and Medicaid fraud investigation. While there are obviously numerous points along the spectrum between a purely public regulator like the IRS and a purely private "regulator" like a voluntary standard-setting organization, the regime I favor features a strong regulator with minority representation from the sector along with significant government representation. Its closest analogues in the securities industry are FINRA itself and the Public Companies Accounting Oversight Board (PCAOB) created by the

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Sarbanes-Oxley Act of 2002¹ to oversee public company auditors. Although there are important differences between these models, both offer several advantages over the current IRS-managed enforcement structure. They also preserve important advantages of a self-regulatory model while mitigating its potential drawbacks.

I. THE NEED FOR SELF-REGULATION

When I first proposed shifting to an SEC/NASD model for charity enforcement, many of my reasons did not depend at all on the self-regulatory features of that model. Rather, I hoped that a new model would not be saddled with some of the specific burdens associated with using the Internal Revenue Service as a standards enforcer. While those specific burdens still exist, the intervening years have underscored the importance of adding an element of self-regulation to the current regulatory model, as well as a mechanism for coordinating federal and state oversight efforts.

A. An Overview of Charity Regulation by the IRS

Over forty years have passed since the Tax Reform Act of 1969 dramatically expanded the oversight role of the Internal Revenue Service with regard to private foundations. At the time, then-IRS Commissioner Randolph Thrower committed to an expansion of the resources that the Agency devoted to the task, promising to audit all private foundations at least every five years and major foundations every two years.² However, the IRS was not able to maintain its increased level of enforcement; while the number of examinations of tax-exempt organization returns temporarily swelled to 13,000 in 1966 (up from 2,000 in 1962), by 1970 it had fallen back to 8,500 returns.³ And while the legislative history of section 4940 of the Internal Revenue Code suggested that Congress intended to link the level of funding of IRS oversight to the amount of taxes collected through the excise tax on the net investment income of private foundations,⁴ in practice an amount that represents no more than a small portion of that tax has even been dedicated to exempt organizations oversight. While it is difficult to obtain precise data on amounts currently spent on oversight, In Congressional testimony in 2007, Steven T. Miller, then Commissioner of the Tax Exempt and Government Entities Division, testified at a House Ways and Means Oversight Subcommittee Hearing that the FY 2008 budget for his Division included a \$26,400,000 increase which he equated to an increase of 10.8%, thus

¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (hereinafter “Sarbanes-Oxley Act”).

² In analyzing IRS statistics regarding examination activity, it is important to note that the data are sorted by returns examined, not taxpayers or tax-exempt organizations, so the examination of a single tax-exempt organization for two years will be reflected in IRS statistics as two returns having been examined. The data also reflect examinations closed in a particular fiscal year, regardless of when they are begun, and the data do not include examinations that are underway in a given year but do not close that year. As a result, the data cannot be used to calculate the percentage of tax-exempt organizations reviewed each year. Because of consistent sorting over time, however, the data do provide an approximate measure of the level of examination activity that can be compared year to year. David Ginsburg et al., *Federal Oversight of Private Philanthropy*, in 5 Research Papers, 2575, 2585 (The Department of the Treasury 1977).

³ *Id.* at 2584.

⁴ Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172, at 29 (Comm. Print 1970).

suggesting a budget that fiscal year for all of the Tax Exempt and Governmental Entities Division of approximately \$244,000,000.⁵ The budget for the Tax Exempt and Governmental Entities Division would include amounts for the Employee Plans function, the Governmental Entities, Indian Tribes and Tax-Exempt Bonds, in addition to funds for the Exempt Organizations Division. IRS data on the section 4940 excise tax is reported on a calendar year basis, making comparisons difficult, however, in calendar year 2008, the IRS reported collecting \$289,068,000.⁶ Even with the effect of the stock market decline in 2008 (the section 4940 tax in 2008 represented a 23.5% decline from the amount collected in 2003), the excise tax on the net investment income of private foundations represented an amount that was likely twice, or more, the amount budgeted for IRS oversight of tax-exempt organizations.

Various attempts to restructure the IRS to improve its ability to oversee exempt organizations have had limited effect. Commissioner Thrower committed to doubling the number of revenue agents assigned to examinations of tax-exempt organizations and establishing a “key district” system in the National Office Audit Division under the Assistant Commissioner (Compliance) to better focus examination resources. Quite early in the post-1969 era of IRS oversight, Congress already seemed to recognize the institutional pressures that would make it difficult for exempt organizations oversight to compete for institutional attention with other larger sources of tax revenue. In 1974, Congress created the position of Assistant Commissioner (Employee Plans and Exempt Organizations) (“EP/EO”) to ensure institutional attentiveness to the task of administering the tax laws applicable to pensions and tax-exempt organizations.⁷ Other high-level positions, known as “Assistant Regional Commissioners (EP/EO),” were created to oversee field operations.

But shortly after the preceding steps to strengthen oversight were implemented, the IRS began reducing the size and scope of its oversight structure for employee benefits and tax-exempt organizations matters. The initial step was taken in 1978, with the elimination of the seven Assistant Regional Commissioner positions by combining the positions with the Assistant Regional Commissioner (Examination), each of which had broad oversight responsibility for all IRS examination programs in a given Region. In the 1980’s, the 21 Key Districts were reduced to seven, with each EP/EO Division Director in a Key District reporting to a District Director who had responsibility for all federal tax matters, including for-profit organizations, tax-exempt entities, tax collection activities and criminal investigations, in the Key District. As a result of the most recent reorganization, there are now five Exempt Organizations Area Offices with responsibility for examinations of tax-exempt organizations, generally equivalent to the former

⁵ *Tax Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H.R. Comm. of Ways and Means*, 110th Cong. 12-25 (2007) (testimony of Steven T. Miller, Comm’r, Tax Exempt and Gov’t Entities Div.).

⁶ Cynthia Belmonte, *Domestic Private Foundations and Excise Taxes, Tax Year 2008*, Stat. of Income Bull., 96 fig.D, 91-130 (Winter 2012).

⁷ The Employee Retirement Income Security Act of 1974 (“ERISA”) created section 7802(b) of the Internal Revenue Code which brought together, under the new Assistant Commissioner (EP/EO), oversight functions regarding pensions and tax-exempt organizations that had formerly existed as branches and other subunits of IRS offices with broader functional responsibilities. In addition to the Office of the Assistant Commissioner (EP/EO), the administrative structure included a field office component operating under a network of seven “super-grade” (GS-16 and higher) Assistant Regional Commissioners (EP/EO) at the IRS Region level and twenty-one EP/EO Divisions at the Key District Office level. The EP/EO function had been authorized 21 dedicated super-grade positions, although that number of higher graded positions was never implemented.

Key Districts, and a separate office was created for processing of applications for exemption, all of which fall under the purview of the Director, Exempt Organizations Division.

While the most recent restructuring at least guarantees a high-level office within the IRS with its attention focused on exempt organizations matters, IRS enforcement simply has not kept pace with the sector's explosive growth or with its increasing sophistication. At the time the 1969 Tax Reform Act was passed by Congress, the total number of tax-exempt organizations on the IRS master file, the computer list of all tax entities, was 643,586 of which 220,074, or approximately 34%, were recognized as exempt under section 501(c)(3) of the Code.⁸ One year later, the number of examinations of exempt organizations returns was approximately 8,500. In 2011, the most recent year for which the IRS has published statistics, the number of tax-exempt organizations listed on the master file was 1,494,882, of which 1,080,130 were exempt under section 501(c)(3).⁹ The IRS reported that it examined 3,210 returns filed by tax-exempt organizations in that same year.¹⁰ Thus, while the number of organizations has more than doubled, the number of examinations is approximately a third of what it was. In addition, the scope of the responsibility of the Exempt Organizations component of the IRS has been increased to include political organizations described in section 527, further increasing the total number of organizations that need to be added to the master file data to get a sense of the responsibilities of the Exempt Organizations Division. In January 2013, the Division's responsibilities were further expanded to include the processing of applications from farmers cooperative organizations described in section 521 of the Code.¹¹

B. Limitations of IRS-Based Oversight

The IRS faces a number of significant challenges in meeting its oversight responsibilities for tax-exempt organizations. In many respects, the challenges have remained essentially unchanged in the nearly 40 years since the general framework for current oversight was put in place by ERISA in 1974. While the level of funding by Congress and the Executive Branch is, perhaps, the most common concern expressed by commentators, other factors also have a negative impact on IRS oversight of tax-exempt organizations.

1. Inadequate Funding

The number of tax-exempt organizations continues to grow and there is every indication that the number will continue to increase.¹² IRS staffing and other resources dedicated to tax-exempt organization oversight have fallen or remained stagnant, and there is no evidence that historic levels of oversight have been adequate to ensure that significant abuses can be identified and addressed in a timely manner.¹³ Because of the dynamic of the federal budget process, noted as far back as 1977 by the Filer Commission,¹⁴ the original intention that an amount of funds equivalent to the amount collected under the section 4940 tax be spent on tax-exempt organizations oversight has never been realized. Executive Branch budget requests and

⁸ 1969 Comm'r of Internal Revenue Ann. Rep. 14.

⁹ 2011 I.R.S. Data Book, 56 tbl.25.

¹⁰ *See id.*, 33-34 tbl.13. The total of 3,210 returns was composed of 2,962 Forms 990 and 990-EZ, 240 Forms 990-PF, 5227, 1041A, and 1120, and 8 Forms 1120-POL.

¹¹ 2012 I.R.S. Exempt Org. Ann. Rep. & 2013 Workplan 3.

¹² 2006 I.R.S. Data Book, 56 tbl.25.

¹³ Indeed, the periodic statements by Treasury and IRS officials, such as those made by Commissioner Thrower, suggest that the level of oversight is consistently inadequate to police marginal tax behavior by tax-exempt organizations.

¹⁴ Ginsburg et al., *supra* note 2, at 2621.

Congressional appropriations, to the extent that they identify amounts for oversight of tax-exempt organizations, bear no relationship to the section 4940 tax. As resources devoted to tax-exempt organization oversight are not regularly published, no comparisons over time of the amount collected under the section 4940 tax and the amount of resources allocated to tax-exempt organizations oversight can easily be made. However, it is quite likely that the section 4940 tax generates amounts of revenue to the federal government that far exceed the amounts spent by the IRS on oversight.

2. Civil Service Constraints

A separate and more significant challenge, over and above the question of annual budgets, is the larger issue of the ability of the federal government to be competitive in hiring and retaining qualified personnel. Effective tax administration requires highly trained accountants, attorneys and other professionals to review increasingly complex financial transactions and relationships. The compensation that can be offered by the IRS is set on a government-wide basis, and while adjustments can be made based on geographic differences in the cost of living and through intentional manipulation of job descriptions, those steps are limited in impact and number. Historically, it has been very difficult for the IRS to compete with the private sector for specialized personnel, particularly in large metropolitan areas. For more senior or experienced positions, salary differentials with the private sector can be significant. For example, the maximum base compensation of the Senior Executive Service, the highest level of career employee in the federal government, is currently fixed at approximately \$179,700,¹⁵ or approximately the salary of a mid-level associate in a large law firm.¹⁶ In addition, according to the Office of Personnel Management website, the compensation levels of the Senior Executive Service has been frozen at the 2010 level.

3. Institutional Constraints

The primary functional role of the IRS is to ensure that taxpayers, whether individuals or businesses, pay the appropriate amount of federal income tax. As a result, IRS systems and procedures are designed to support that tax-collecting role. Historically, IRS internal management information systems have been designed to track tax returns and related matters for for-profit organizations and individuals, and then adapted to address some of the management information requirements of the tax-exempt organizations function, which, of course, is a rational, economic approach to the task.

Other IRS systems follow this pattern of development, as well. For example, electronic filing systems and procedures for the Form 990 series returns, despite the unique public nature and function of the returns, has been a by-product or off-shoot of the planning, development and implementation process of the electronic filing of the corporate tax return, the Form 1120. Even the development of formal guidance in interpreting federal tax law applicable to tax-exempt organizations must compete for institutional attention with revenue-producing matters at top levels within the IRS and at the Department of the Treasury.

¹⁵ See Office of Personnel Mgmt., *Rates of Basic Pay for Members of the Senior Executive Service (SES)*, tbl.2012-ES, available at <http://www.opm.gov/policy-data-oversight/pay-leave/salaries-wages/2012/executive-senior-level/es.pdf>.

¹⁶ Press Release, Nat'l Ass'n for Law Placement, Median First-Year Big-Law Associate Salary Slumps to \$145,000 in 2012, a Median Last Seen in 2007, 2 tbl.1 (Sept. 20, 2012), <http://www.nalp.org/uploads/PressReleases/2012ASSRPressRelease.pdf>.

4. Tax Law Anomalies/Reliance on Tax-Based Oversight

The authority given to the IRS to serve as the sole nationwide regulatory function for tax-exempt organizations is limited by the specific language and scope of the Internal Revenue Code. For example, the enforcement of some of the penalty-like excise taxes applied to tax-exempt organizations, which are intended to discourage certain egregious behavior rather than generate tax revenue, is tied to the system of annual filing of tax returns, even though a more timely oversight/reporting mechanism triggered by a particular act or event might be far more effective and certainly would help create a public perception of the policing of bad acts. Examples are section 4958 dealing with excess benefit transactions, section 4941 involving self-dealing, and section 4944 regarding investment policy. Depending on the date of filing, a return for a year in which a particular questionable financial transaction occurs or investment is made might be filed as much as ten months and fifteen days after the close of the year in which it occurred and which could mean as much as nearly two years after the actual occurrence for events that take place early in a given tax year. In the case of political campaign intervention, that will typically be after the election in question is over. It would be far more effective, for example, if the reporting of the transgression was required to be made within a relatively short period of the discovery of the event, thus allowing for a quick IRS review of the accuracy of the return and its reflection of the underlying events.

Relying on an annual tax return filing as the trigger for regulatory action makes it impossible to address issues of concern in a timely manner. The Internal Revenue Code recognizes the need for quick action in the case of “flagrant” violations of the prohibition on political expenditures, allowing the IRS to determine and assess taxes immediately and to enjoin further political campaign intervention.¹⁷ But timely enforcement of standards upon discovery of a violation should be the rule, not the exception, and is, in fact, the case with state attorney general oversight.

Other provisions drafted with tax administration for for-profit organizations and individuals in mind, by their terms, actually hamper efficient and effective administration involving tax-exempt organizations. For example, section 6103 deals with the privacy of taxpayer information and permits close cooperation and information sharing between the IRS and state revenue offices with regard to income tax matters. Because the language of the statute refers to state tax agencies, it precludes a similar level of coordination between the IRS and state charity regulators, a function that is typically not placed in tax agencies at the state level.¹⁸ Until recently, pursuant to section 6104, only notice of actual denials of exempt status or imposition of tax under chapter 41 or 42 or section 507 could be revealed.¹⁹ The Pension Protection Act of 2006 expanded this exception to allow disclosure when such actions are proposed, but only at the request of the relevant state official and as necessary for the administration of state law.²⁰ It allows disclosure of other information only if the IRS determines that the information potentially provides evidence of state law noncompliance.²¹ While these changes are an improvement, they still prohibit routine sharing of information with state authorities in the absence of a suspicion of wrongdoing. Given the public nature of charities, charity regulation should not be shackled to these kinds of strict limits on disclosure that are designed to protect private persons’ confidential

¹⁷ I.R.C. §§ 6852, 7409

¹⁸ I.R.C. § 6103(d)

¹⁹ I.R.C. § 6103(c)(1) (2005)

²⁰ *Id.* § 6103(c)(2)(A)-(B).

²¹ *Id.* § 6103(c)(2)(D).

tax information, but instead provide regulatory arbitrage opportunities for organizations seeking to control regulator access to information.

C. Recent Developments Underscoring the Need for More Self-Regulation

An alternative approach to charity regulation might help the charitable sector break out of its perennial cycle: while media reports of abuses periodically elicit cries for more restrictive regulatory or even statutory standards, charity enforcement consistently loses out to other priorities in the budget appropriations process, which consistently leads to more abuses, and so on. When I first advanced the idea of an alternative model in 2004, the most recent examples of this phenomenon were media reports of supporting organizations conferring private benefits on their donors, Internal Revenue Service (“IRS”) promises of increased enforcement,²² and the Senate Finance Committee staff “White Paper” raising the possibility of significant statutory change to foreclose the publicized abuses.²³ On the appropriations side, however, Congress indicated that the IRS budget would be less than requested (as usual), and the IRS indicated that enforcement might suffer as a result (as usual).²⁴ The problem I focused on then was the chronic inability of the IRS to obtain enough resources to prevent abuse in the charitable sector. In contrast, the self-regulatory organizations overseen by the SEC have a constant stream of dues and other fees from which to finance their enforcement efforts.

The legislative response set in motion in 2004 and culminating in the charitable reforms of the Pension Protection Act of 2006 underscores another equally troubling side to the cycle of underenforcement, abuse, and sporadic legislative attention. As the PPA demonstrates, when legislative attention focuses on the charitable sector only when there are well-publicized abuses, there is a risk of strict rules targeted at specific abuses that do not take adequate account of the hardships they impose on legitimate organizations. To prevent that result, charities need some institutional voice that can accurately and credibly inform Congress about the consequences of its proposed rules—or better yet, design rules that will not have those negative effects, making legislation unnecessary.

To be sure, the sector did have some involvement in the process that led to the PPA. In immediate response to the Senate Finance Committee proposals, Independent Sector convened the Panel on the Nonprofit Sector to review a broad range of issues affecting the sector, including but not limited to those identified by the Senate Finance Committee, and to provide recommendations to Congress, Treasury, and the sector itself on how to improve charities’ governance, transparency, and accountability.²⁵

²² I.R.S. News Release IR-2004-81 (June 22, 2004); I.R.S. News Release IR-2004-106 (Aug. 10, 2004).

²³ See Staff of S. Comm. on Finance, 108th Cong., Tax Exempt Governance Proposals: Staff Discussion Draft (Comm. Print), available at <http://www.finance.senate.gov/imo/media/doc/062204stfdis.pdf>.

²⁴ Allen Kenney, *More Capital Hill Skirmishes Likely on IRS Budget*, 104 Tax Notes 1002 (2004). “The President’s 2005 budget proposal calls for a greater than 10 percent increase in our enforcement funding. Right now, that request is not faring particularly well with Congress. I ask those involved to take another look and fully fund the president’s request.” Mark W. Everson, IRS Comm’r, Prepared Remarks Before a Press Briefing: Enforcement Revenue Reaches Record in 2004 (Nov. 18, 2004), available at <http://www.irs.gov/uac/Enforcement-Revenue-Reaches-Record-in-2004>.

²⁵ For the results of the Panel’s deliberations, see Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* (2005).

The Panel included representatives from many different charities, and its process involved consultation with numerous subcommittees with expertise in specific areas.²⁶ However, major segments of the charitable sector had little or no representation. Universities and hospitals had no representatives on the Panel itself; only one member of the Panel, from the Evangelical Council for Financial Accountability, could be considered to represent churches. In contrast, almost half of the Panel members represented private foundations. Ultimately, the Panel made a variety of suggestions for reforming donor advised funds and Type III supporting organizations which were picked up, with substantial modifications, in the package ultimately enacted in the Pension Protection Act. Perhaps not coincidentally, the PPA's new restrictions on supporting organizations are especially likely to affect universities and hospitals, which (unlike private foundations) frequently employ multi-entity structures involving supporting organizations. Private foundations, on the other hand, were largely unaffected by the new legislation; the primary effect of the PPA on them was to make it more difficult for a private foundation to give to supporting organizations.²⁷

I do not mean to fault the Panel too much. It is difficult to construct a body that comes close to representing the numerous voices within the sector under the best of conditions, and the Panel was an ad hoc body that had to be assembled on relatively short notice. Furthermore, it was faced with a number of Senate Finance Committee staff proposals that expressed strong hostility to supporting organizations from the outset; for the most part, the Panel's recommendations and the PPA provisions actually enacted were less severe than those initial proposals. However, I think the limitations of the Panel demonstrate the value that a more permanent body with enforcement responsibilities could have. In addition to improving enforcement efforts by providing an appropriations-independent source of funds for such enforcement (and thus hopefully stopping abuses before they trigger the Congressional legislative reflex), such a body could have representation from throughout the sector and could serve as a natural information source for Congress when it did legislate.

Other recent developments in the sector underscore the need for better channels for sector input into the regulatory process. First, 2007 saw the end of a 20-year hiatus in authoritative revenue rulings on political campaign intervention.²⁸ That gap means that charities have in many cases had no guidance (or at most a stray statement in IRS training materials or nonprecedential letter rulings) to help them apply the law to an advocacy environment that has undergone a technological revolution during that time. Not until Revenue Ruling 2007-41 did we have binding IRS authority in this area that even contemplated the existence of the internet. And while Revenue Ruling 2007-41 did provide some guidance, it continued the IRS's pattern of insisting that political campaign intervention be determined on a case-by-case basis but providing examples dealing mainly with extreme cases, leaving practitioners and the charities they represent unsure about how far their activities can go without constituting prohibited political activity.²⁹

²⁶ See *id.* at i, 99-108.

²⁷ See I.R.C. §§ 4942(g)(4), 4945(d)(4)

²⁸ Rev. Rul. 2007-41, 2007-25 I.R.B. 1421.

²⁹ For example, Revenue Ruling 2007-41 suggests that organizations may be guilty of campaign intervention when they link to content that is unduly political. The IRS does provide an example of a hospital linking to a newspaper story about the hospital, and states that this will not be political campaign intervention even if another unrelated portion of the newspaper's website contains editorials endorsing candidates. See *id.*, Situation 20. While that seems to be obviously the correct result, it is troubling that the IRS chose as its positive example a case so clear that it adds nothing to charities' understanding of the line between permissible and impermissible conduct. If anything, the

To take another recent interaction between the government and the charitable sector, for a number of years, Independent Sector, the Council on Foundations, and others have been engaged in a prolonged process of engaging with the Treasury Department over its “Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities.”³⁰ These groups have voiced strong concerns that the procedures recommended by Treasury are inadvisable or infeasible for many charities. While Treasury has modified its proposal in some respects, it ignored other suggestions.³¹ The standards ultimately developed were, based on public comments, of questionable legal import and were difficult, as well as costly, to implement even by the most well-intentioned tax-exempt organization.³²

These examples show the limitations of a process in which only government officials have a role in the guidance drafting process, with either no formal input from the sector in the case of Revenue Rulings or input limited to the formal public comment process and any informal contacts government drafters may happen to have, which leaves little chance for back-and-forth negotiation to find solutions mutually acceptable to the government and the governed alike. All too often, IRS priorities will be focused on preventing abuses and making sure that issued guidance preserves its flexibility to stop abuse. Greater sector representation *within* the body responsible for regulating charities would give charities the chance to influence guidance priorities to ensure that due attention is also given to formulating rules identifying areas of permissible conduct. Indeed, charity representatives could even propose such clarifications for consideration. Furthermore, a properly structured regulatory body with representatives from both the IRS and the sector would provide a much more fluid mechanism for ensuring that charities’ legitimate needs are adequately taken into account in the development of regulations and other authoritative guidance.

II. PRECONDITIONS AND PROBLEMS OF SELF-REGULATION

Self-regulation is an expansive term that has been used to describe everything from an organization’s voluntary adoption of an aspirational policy statement, to voluntary compliance with industry best practice standards enforced by various accrediting bodies, to government-imposed regulation in which the regulated industry itself has some voice. The fundamental idea is that, at least in some contexts and if properly supervised, the participants in an activity are best suited to set and enforce the rules governing that activity. Critics, on the other hand, warn that

example raises questions about whether other seemingly unproblematic links might raise IRS hackles—for instance, what would the IRS analysis be if the story featuring the hospital were on the same page with a political editorial?

³⁰For the government’s summary of the course of this engagement, see U.S. Dept. of the Treasury, *Response to Comments Submitted on the U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities*, available at <http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/response.pdf>.

³¹ See *Treasury Releases Third Version of Anti-Terrorist Financing Guidelines*, Center for Effective Government, Formerly OMB Watch (Oct. 11, 2006), <http://dev.ombwatch.org/node/3077>.

³² See Letter from Steven Gunderson, President & CEO of a member organization, the Treasury Guidelines Working Group, to the Office of Terrorist Financing and Financial Crime, U.S. Department of the Treasury (Feb. 1, 2006) (on file with author) (criticizing the Guidelines and proposing Principles of International Charity in their place), available at www.usig.org/PDFs/Comments_to_Treasury.pdf; Letter from Steven Gunderson, President & CEO of a member organization, the Treasury Guidelines Working Group, to the Hon. Henry M. Paulson, Jr., Secretary of the Treasury (Dec. 18, 2006) (on file with the author) (reiterating the call to withdraw the Guidelines), available at http://www.cof.org/files/Documents/International_Programs/TreasuryLetter.pdf.

reliance on self-regulation is the equivalent of letting foxes guard the henhouse, allowing the self-regulating community to forestall government regulation by voluntarily adopting norms that in practice the self-regulators will have little incentive to enforce against themselves whenever the stakes are high.

A. Conditions in Which Self-Regulation is Advantageous

Despite the ever-present danger that the self-regulating community will not adequately police its rules, self-regulation can offer important advantages. In some cases, that is because the participants' knowledge of the activity situates them to craft effective, feasible rules while a government regulator with less familiarity with the area might create rules that would be impossible or costly to implement given existing practices. In others, the potential costs or harms of the activity fall largely on the participants, so that the broader interests of the public and the government are only tangentially implicated. Self-regulation may also be advantageous when participants in the activity have superior access to the information necessary to detect violations. Finally, self-regulation may be a way of exporting the costs of regulating the activity from the public fisc to the participants in that activity.

These advantages all presuppose that the members of the self-regulating group have sufficient incentive to impose effectively enforced standards against one another. That incentive is most likely to exist when the behavior of group members directly impacts other group members or when they are engaged in a joint project. But even when members of the regulated community are not interacting with each other directly, they may still have incentives to hold each other to high standards of conduct. First, to the extent such organizations compete with one another, they may agree to common rules in the interest of ensuring a level playing field. Furthermore, when a group is dependent on the good graces of the public or the government, it may seek to enforce minimum standards of conduct because of bad actors' negative impact on the reputations of other members of the group and the resulting increase of public or governmental suspicion.

Many of the foregoing factors are present in the securities industry, which explains why self-regulation, despite periodic critiques, has remained a key part of the U.S. regime governing securities and securities dealers. National stock exchanges, for instance, of necessity required the participants to come together and develop rules for the smooth operation of their exchanges. Because members of the stock exchange were buying and selling from each other and dependent on the smooth functioning of a common market, they all had a common direct financial interest in establishing rules for the market by which all participants would abide in order to protect their own direct financial interests, in addition to the need of protecting the traders' reputation with potential customers. Indeed, these incentives caused securities traders to form the New York Stock Exchange to govern their common conduct in the late eighteenth century, long before the creation of the SEC. While it evolved somewhat more recently, the NASD has shared these features as well, especially with the rise in prominence of the NASDAQ as a competitor to the NYSE.

Three other conditions favor self-regulation in the securities context. First, NASD or stock exchange members' intimate familiarity with market practices has allowed them to identify areas where additional rules are needed as those practices evolve. Second, the fact that the major self-regulatory bodies have until recently directly operated their own markets meant that they could use information already gathered in the course of running those markets to track compliance with their rules. Third, self-regulation allows securities regulation to be paid for in

large part by the organizations trading in securities, both through their annual dues and through fees collected in the course of market operations. This allows the SEC to leverage its limited enforcement budget by overseeing the enforcement efforts of private self-regulatory organizations (“SROs”). Thus, both in terms of incentives, capabilities, and resources, national exchanges like NYSE and the NASD have historically been an advantageous locus of regulation.

I. Managing the Potential Weaknesses of Self-Regulation: Recent Lessons from the Securities Industry

Even when a group has the incentives and capability to regulate its own behavior, such self-regulation must be structured to manage the conflicts of interest inherent in giving the regulated community influence over rulemaking or adjudicatory decisions that may be adverse to that community’s interest. The recent history of the NASD is instructive in this regard. For many years, a majority of the NASD Board of Governors consisted of directors elected at large by the membership or representatives of NASD regional district committees; the By-Laws ensured that members always controlled a majority of the NASD Board.³³ Member representatives on and off the Board of Governors also dominated key NASD policy-setting committees. Furthermore, local district committees composed of NASD governors and local NASD members had authority to conduct disciplinary proceedings, with the result that an accused party’s direct competitors could be put in a position to judge that party’s case.³⁴

The inherent conflicts in such a structure were highlighted in a 1996 SEC report censuring the NASD for, among other things, vigorously enforcing its rules against day traders while ignoring anticompetitive price quoting practices engaged in by market makers, who dominated the key Trading Committee of the NASD. In the wake of that scandal, the NASD substantially increased the number of non-industry and public directors on its board, making member representatives only a minority. Furthermore, it moved key functions such as the regulatory function into separately incorporated subsidiaries with a majority of independent board members (including some purely public board members with no ties to the securities industry). It also put neutral hearing officers with legal training in charge of administering disciplinary hearings. And although industry representatives at the district level still sat on disciplinary panels, their findings could be appealed to a National Adjudicatory Council, a body with a majority of independent directors and that renders decisions based on its precedents as well as those of the SEC and the courts.³⁵

While the SEC agreed to settle its charges in return for these changes at the time, eight years later a growing list of regulatory failures by the NASD or other SROs caused the SEC to publish a concept release reviewing the fundamental philosophy of self-regulation and considering various alternative structures for securities regulation.³⁶ While it recognized the difficulty it would have policing the securities markets by itself, it continued to express concern about whether placing decisions about enforcement under the control of separate subsidiaries or subcommittees with independence could adequately insulate those decisions from the interests of

³³ See Securities and Exchange Comm’n, *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market* (Aug. 8, 1996), at 9, available at <http://edgar.sec.gov/litigation/investreport/nd21a-report.txt>.

³⁴ *Id.* at 10.

³⁵ *Id.* at 5.

³⁶ Concept Release Concerning Self-Regulation, Release No. 34-50700, 69 Fed. Reg. 71,256 (Dec. 8, 2004), available at <http://sec.gov/rules/concept/34-50700.pdf>.

members if those members ultimately elected an SRO's board and provided its funds. The following are some of the key conflicts that the SEC was concerned with in 2004:

- Dependence on member fees could make SROs unwilling to regulate major funders aggressively, especially since consolidation within the industry had left some SROs receiving over 20% of their revenues from one member company.
- Competition among SROs (particularly among exchanges competing for stock listings) could drive a "race to the bottom," with each SRO seeking to attract issuers with more forgiving standards and lower fees (and hence lower enforcement budgets).
- Because most securities SROs also provide other services or maintain markets, they may be tempted to underallocate resources to enforcement, which cannot promise the same sort of financial return that other services to market participants might.
- The foregoing concerns could be exacerbated by the demutualization of certain SRO market operators, creating a new class of investors in SROs who could be expected to demand profit-driven decisions about enforcement levels.

Of course, Congress was not unaware of these kinds of concerns (except possibly the last one) when it chose to rely on SROs for frontline enforcement of the securities laws. Its preferred method of keeping these institutional conflicts in check was to give the SEC broad powers to oversee private SROs, allowing it to amend their internal rules without their consent and to review their disciplinary decisions *de novo*. The SEC's Concept Release is thus best understood as expressing its frustrations with a system that forces it to monitor the SROs and prevent any abuses while at the same time structuring the SROs in a way that guarantees some incentives to engage in those abuses.

III. NEW MODELS FOR LIMITED SELF-REGULATION

Two recent models from the financial sector and securities industry are notable because they attempt to combine a measure of self-regulation tempered by enough independent directors or governmental control to prevent the kinds of conflicts of interest that have plagued traditional SRO models. The first is FINRA, the result of the NASD's merger with the regulatory function of the NYSE, which has continued to move away from an industry-dominated structure toward a more independent structure. The second is the PCAOB, a government-controlled organization responsible for oversight of the audit of public companies.

A. FINRA

Under the Securities and Exchange Act of 1934 (the "1934 Act"), all registered securities dealers are prohibited from engaging in a broad range of securities transactions unless they are members of a SRO. If they restrict themselves to transactions on a particular exchange registered with the SEC, that requirement can be satisfied by membership in that exchange; otherwise they must be members of an association of dealers (i.e., FINRA).³⁷ Either type of

³⁷ 15 U.S.C. § 78o(b)(8)

SRO must prove to the SEC that it has the capacity to enforce both its own rules as well as the provisions of the 1934 Act and the regulations promulgated thereunder.³⁸ FINRA and other SROs have a broad mandate to adopt rules designed to accomplish any of several purposes including the prevention of fraudulent and manipulative acts and practices, the promotion of just and equitable principles of trade, and the protection of investors and the public interest.³⁹ In addition, each SRO's internal governance structure must "assure a fair representation of its members in the selection of its directors and administration of its affairs," provide for equitable allocation of fees, and provide for at least one director representative of issuers and investors and not associated with the SRO's members, brokers, or dealers.⁴⁰ The 1934 Act also imposes various requirements on SROs to ensure that they have fair procedures for admitting and disciplining members.⁴¹ However, within the confines of these general requirements, SROs have considerable latitude in how they structure their affairs.

Under the revised FINRA Bylaws recently approved by the SEC, FINRA's Board of Governors will include ten industry representatives elected by various constituencies within the industry (three representatives elected by large members, three representatives elected by small members, one representative elected by mid-size members, and three members appointed by the Board representing a floor member of the NYSE, an investment company, and a financial planning firm or life insurance company).⁴² Another eleven directors will be "public directors" selected by the current Board of Directors; they must meet criteria guaranteeing their independence from NASD members or others within the industry.⁴³ Finally, the CEO of FINRA serves as an ex-officio board member.⁴⁴ Thus, only seven of 22 Governors are directly elected by FINRA member firms, and a majority must be independent.

While FINRA may have advisory committees with more member representation, any committee authorized to exercise the Board of Governor's powers must include a majority of independent directors.⁴⁵ A corollary of this is that independent directors control the nominating committee, giving them significant voice in the selection even of the elected industry representatives. On the other hand, members also retain a strong voice in the institution. In addition to electing a minority of directors, they retain the right to approve any changes to the By-Laws, and can by petition propose their own changes to the By-Laws and their own alternative candidates to those provided by the Nominating Committee.⁴⁶ FINRA's regulatory subsidiary relies on panels consisting of a hearing officer (in essence, an administrative law judge) as well as two individuals currently or formerly associated with members.⁴⁷ These panels handle disciplinary matters in the first instance, but after that decisions are appealed to a National Adjudicative Committee with a majority of independent directors.⁴⁸

³⁸ *Id.* §§ 78f(b)(1), 78o-3(b)(2) .

³⁹ *Id.* §§78f(b)(5), 78o-3(b)(6).

⁴⁰ *Id.* §§ 78f(b)(3)-(4), 78o-3(b)(4)-(5).

⁴¹ *See, e.g., id.* §§ 78f(c)-(d), 78o-3(g)-(h).

⁴² *See* Restated Certificate of Incorporation of Financial Industry Regulatory Authority, Inc., art. 8(b), available at <http://www.finra.org> (hereinafter "FINRA Certificate").

⁴³ *See id.*, art. 12(U).

⁴⁴ *See id.*, art. 8(b).

⁴⁵ *See* By-Laws of Financial Industry Regulatory Authority, Inc., art. IX, § 1(b). (hereinafter "FINRA By-Laws").

⁴⁶ *See id.*, art. VII, § 11; *id.*, art. XVI, § 1.

⁴⁷ NASD Manual, Rule 9231, available at <http://www.finra.org>.

⁴⁸ By-Laws of NASD Regulation, Inc., § 11.2, available at <http://www.finra.org>.

In several key respects, FINRA is subject to the ultimate oversight and control of the SEC. Major FINRA rule changes must be approved by the SEC after notice and comment from the public before they take effect (unless the SEC determines that the rule must go into effect immediately to protect the public interest)⁴⁹; rules that merely interpret pre-existing rules or that merely set or change fees can go into effect immediately but are still subject to SEC review after notice and comment.⁵⁰ The SEC also retains the power to amend FINRA rules and bylaws unilaterally through the rulemaking process.⁵¹ However, as a person “adversely affected” by SEC changes to its rules (or SEC rejections of its proposed rule changes), FINRA can ask a federal appeals court to review the SEC action for abuse of discretion.⁵² FINRA’s disciplinary actions are also subject to review by the SEC, which may nullify or ameliorate any sanctions imposed by FINRA.⁵³ FINRA itself cannot appeal such actions, but the aggrieved party can seek review of the SEC order in the appellate court.⁵⁴ The SEC can seek judicial enforcement of its orders, including orders upholding FINRA fines or similar sanctions.⁵⁵ In rare cases, the SEC may enforce FINRA rules directly, but only if there is some reason FINRA cannot be expected to enforce the rules itself or SEC action is otherwise necessary to protect investors or the public interest.⁵⁶ Finally, the SEC may investigate FINRA and impose sanctions on FINRA for failures to fulfill its regulatory responsibilities under the 1934 Act.⁵⁷

Because FINRA is not funded or controlled by the government and does not receive its funding from the government, its status (or, to be precise, its precursor NASD’s status) as a private entity has been upheld in several key respects by the courts. In particular, while it receives absolute immunity from suit for damages arising from its regulatory functions,⁵⁸ it is not considered a state actor and is therefore not subject to the Fifth Amendment.⁵⁹ For instance, it can demand that its members testify or produce documents in its proceedings regardless of whether such testimony or evidence would be self-incriminating, and can impose sanctions for their failure to testify or give FINRA access to their files.⁶⁰ Because its actions do not constitute

⁴⁹ 15 U.S.C. § 78s(b)

⁵⁰ 15 U.S.C. § 78s(b)(3)

⁵¹ *Id.* § 78s(c).

⁵² *See Nat’l Ass’n of Sec. Dealers, Inc. v. SEC*, 431 F.3d 803, 809 (D.C. Cir. 2005).

⁵³ *See* 15 U.S.C. § 78s(d)-(f)

⁵⁴ *See Nat’l Ass’n of Sec. Dealers, Inc. v. SEC*, 431 F.3d at 809-10.

⁵⁵ 15 U.S.C. § 78u

⁵⁶ *Id.* § 78u(f).

⁵⁷ *Id.* § 78s(h).

⁵⁸ *See Zandford v. Nat’l Ass’n of Sec. Dealers, Inc.*, 80 F.3d 559 (D.C. Cir. 1996); *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1215 (9th Cir.1998); *Austin Mun. Sec., Inc. v. Nat’l Ass’n of Sec. Dealers, Inc.*, 757 F.2d 676, 692 (5th Cir. 1985).

⁵⁹ *See Desiderio v. Nat’l Ass’n of Sec. Dealers, Inc.*, 191 F.3d 198, 206 (2d Cir. 1999) (“The NASD is a private actor, not a state actor. It is a private corporation that receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee.”); *cf.* *United States v. Solomon*, 509 F.2d 863 (2d Cir. 1975) (holding that the New York Stock Exchange is a private actor). *But see Intercontinental Indus., Inc. v. Am. Stock Exch.*, 452 F.2d 935, 941 (5th Cir. 1971) (holding that another SRO, the American Stock Exchange, was subject to the Fifth Amendment because of its close connection to the SEC). For arguments that SROs’ regulatory roles should make them subject to the Fifth Amendment, *see* Richard L. Stone & Michael A. Perino, *Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 Colum. Bus. L. Rev. 453; William I. Friedman, *The Fourteenth Amendment’s Public/Private Distinction Among Securities Regulators Revisited*, 23 Ann. Rev. Banking & Fin. L. 727 (2004).

⁶⁰ *See United States v. Solomon*, 509 F.2d 863 (2d Cir. 1975).

final action on behalf of the SEC (which is always allowed to review FINRA's actions *de novo*) or any other federal agency, FINRA's officers are not considered officers of the United States. Thus FINRA is not subject to the Appointments Clause of the Constitution, which requires that all such officers be appointed by the President with the advice and consent of the Senate or (in the case of inferior officers) by the Heads of Departments.⁶¹ FINRA's private status also means that it has been exempt it from other government-focused statutes like FOIA and the civil service rules of Title 5 of the United States Code.

B. The PCAOB

The Sarbanes–Oxley Act of 2002 provides a slightly different model for how a public/private federal charity regulator might look. That Act establishes the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies subject to the securities laws. The PCAOB shares many features with FINRA and similar SROs. It has broad rulemaking powers allowing it to prescribe attestation, quality control, and ethics standards that it determines to be required by the Sarbanes–Oxley Act, SEC rules, or that are “necessary or appropriate in the public interest or the protection of investors.”⁶² It also has the right to enforce its rules against public accounting companies, imposing a variety of sanctions ranging from fines to suspension of registration to termination.⁶³ And it is authorized to fund its activities by levying an “accounting support fee” (in an amount subject to SEC approval) against the public companies that rely on having their books audited.⁶⁴ Finally, the SEC retains the same authority to amend the PCAOB's governing instruments and to review PCAOB enforcement decisions *de novo* that the SEC has with respect to FINRA and other SROs.⁶⁵

There are two main differences between the PCAOB and FINRA. First, unlike FINRA, the PCAOB is the only SRO for its regulated community. Accordingly, it does not have the same incentives that the securities exchanges have had to lower its fees or its regulatory standards in order to attract members from competing regulators. Second, the PCAOB has no membership or elected industry representation on its board; all five of its directors are appointed by the SEC.⁶⁶ However, it does provide a measure of self-governance by requiring that exactly two of the board members be CPAs.⁶⁷ In addition, the PCAOB can, by designation, adopt all or part of rules produced by other standard-setting groups or expert advisory committees it convenes.⁶⁸ More significantly, it is *directed* to recommend issues for such groups' consideration and to respond promptly to their requests for adjustments to rules under its jurisdiction.⁶⁹

Thus, the PCAOB's structure allows the SEC to keep it from becoming unduly influenced by the accounting profession, while still providing some institutional channels

⁶¹ *Cf. Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000) (finding that administrative law judges whose rulings were reviewed *de novo* were not considered “officers” of the United States subject to the Appointments Clause); *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, No. 06-0217, 2007 WL 891675, (D.D.C. Mar. 21, 2007). (noting the NASD's lack of any independent power to enforce securities laws on behalf of the SEC).

⁶² Sarbanes-Oxley Act, § 103(a)(1).

⁶³ *Id.* § 105(c)(4).

⁶⁴ *Id.* § 108(d).

⁶⁵ *Id.* § 107.

⁶⁶ *Id.* § 101(e)(4)(A).

⁶⁷ *Id.* § 101(e)(2).

⁶⁸ *Id.* § 103(a)(3)-(4).

⁶⁹ *Id.* § 103(c).

through which the accounting profession can have input into the substance of the PCAOB's rules as well as the PCAOB's rulemaking agenda. Moreover, governmental influence over the PCAOB somewhat attenuated, since the PCAOB directors have staggered terms of five years and can be removed only for cause by the SEC,⁷⁰ itself an independent agency. Thus, the PCAOB may develop a perspective distinctly different from that of the SEC, and any Presidential administration will have even more attenuated power to influence the PCAOB.⁷¹

The Sarbanes–Oxley Act repeatedly asserts that the PCAOB is a private nonprofit corporation, not an independent federal agency. Like the 1934 Act, it explicitly allows the PCAOB to impose penalties on registered public accountants for failure to testify in its investigatory proceedings (which a federal agency could not do). However, given the degree of governmental control over the PCAOB, it is less clear that courts will respect its private status in the same way they have respected the private status of the NASD.⁷² The first court decision on this point suggested that the PCAOB's officers are “inferior officers” of the federal government and hence required to be appointed by “Heads of Departments” under the Appointments Clause of the Constitution.⁷³ However, specific provisions of the Sarbanes–Oxley Act indicate that FOIA and (less clearly) the civil service rules will not apply to the PCAOB.⁷⁴

C. Medicaid Fraud Control Units

In 1965, Congress enacted Medicaid to fund the provision of medical services to low income and disabled individuals⁷⁵. The system is financed by both federal and state funds and is administered by the various states. In 1977, Congress addressed the issue of Medicaid fraud by enacting the Medicare–Medicaid Anti-Fraud and Abuse Amendments,⁷⁶ which established the Medicaid Fraud Control Unit (“MCFU”) Program to fund investigation of fraud in the Medicaid program. Each state and the District of Columbia, with the exception of North Dakota, have established investigative units, usually in the state Attorney General's office. The federal government provides 75% of each MCFU's costs, with the remaining 25% provided by the state. The MCFU program operates under the administrative oversight of the Office of the Inspector General of the federal Department of Health and Human Services, which helps ensure that the funds are used for Medicaid-related fraud investigations, rather than other crimes.⁷⁷ In addition to its investigative and prosecutorial role, the MCFU program undertakes analyses of weaknesses in Medicaid rules and programs, recommends appropriate changes in those policies and programs to help minimize misuse of Medicaid funds, and has developed computer programs for reducing fraud and enhancing internal programmatic controls.⁷⁸

⁷⁰ *Id.* § 101(e)(5)(A), (6).

⁷¹ For an argument that this creates a disturbing lack of political accountability, see Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 Notre Dame L. Rev. 975 (2005).

⁷² See Nagy, *supra* note 71.

⁷³ See *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, No. 06-0217, 2007 WL 891675, (D.D.C. Mar. 21, 2007). The district court considered the possibility that this would require appointment by the SEC Chairman rather than by the SEC as a whole, but found the plaintiffs lacked standing to object on that ground, as the vote appointing the PCAOB members had been unanimous.

⁷⁴ Sarbanes–Oxley Act, §§ 105(b)(5)(A), 101(b).

⁷⁵ Social Security Amendments of 1965, P.L. 89-97, 79 Stat. 286, July 30, 1965.

⁷⁶ P.L. 95-142, October 25, 1977.

⁷⁷ See Testimony of D. Mark Collins, Assistant Attorney General and Director, Nebraska Medicaid Fraud Control Unit, and President, National Association of Medicaid Fraud Control Units, before the House Judiciary Subcommittee on Crime, Terrorism and Homeland Security, March 4, 2010.

⁷⁸ *Id.* At 4.

D. Relevance of these Models to the Charitable Context

These models are attractive to me because they give the regulated community a voice in the regulatory process but not a dominant voice. The NASD model abandoned in the 1990s, on the other hand, allowed the regulated groups to control their SROs. Of course, even in that case, the SEC's overriding powers to amend NASD rules and overturn NASD decisions meant that the government retained ultimate control over the content of securities regulation. But the only way for the SEC to exercise that control was to take the reins, as it were, from the SRO in question, which was supposed to be the primary regulator of securities dealer. The NASD had insufficient internal controls to ensure that its industry representatives would adequately take into account the interests of the larger public. In that context, unless a large percentage of the costs of the regulated activity fall on those within that community, the natural incentive of the self-regulatory body is to aim for the most liberal rule, and the most lax enforcement of that rule, that it thinks the supervising government body and the public will tolerate.

The FINRA and PCAOB models, on the other hand, have the advantage that they allow rapprochement between the perspectives of the regulated community and the public or the government to occur *within* the self-regulatory body. That, in turn, should minimize the need for governmental interventions to make course corrections. They do this while preserving the appropriations-independent funding mechanism that has always been one of the chief advantages of the self-regulation system.

The MFCU model demonstrates how dedicated funding for focused investigative resources at the state level, coordinated through a federal agency, can have a significant impact enforcement impact.

These models seem more appropriate for the charitable context than a more robust form of self-regulation. Unlike securities dealers, charities do not have any central market or similar institution in which they routinely interact with each other analogous to the NYSE or the NASDAQ, and most of the restrictions on charities imposed by the tax code, and by state and common law notions of fiduciary duty, do not have to do with their interactions with one another. Accordingly, charities have limited ability and limited incentives to police each other's conduct.

That is not to say that charities have no incentive to maintain high standards within the sector. Publicly supported charities have such an incentive because their dependence on donations from the public makes it important for them to protect the reputation of the sector in the eyes of potential donors. Furthermore, as the PPA demonstrates, anecdotal evidence of abuse in the charitable sector can lead government regulators to impose ill-tailored prophylactic rules prohibiting entire classes of transaction because of the potential of some such transactions to be abusive. Such rules complicate the operations of good and bad charities alike, giving the "good" charities a strong incentive to establish standards for charitable organizations that will prevent both abuse and the overinclusive regulation that sometimes follows. Finally, some areas of exempt organizations law—notably the limits on lobbying and electoral activities—govern activities that pit charitable groups against one another, providing them incentives to insist on common ground rules that will keep their ideological opponents from gaining unfair advantage in the struggle of ideas. For all of these reasons, charities can be expected to have some incentives to support appropriate regulation of the sector.

However, because many of the costs of misbehavior within the charitable sector do not fall on charities, by themselves they might not have incentives to regulate the charitable sector

effectively. To take just one example, charities have minimal incentives to police donors who claim inflated deductions for their in-kind contributions; in this matter, lax enforcement effectively allows a greater federal tax subsidy of the charities' activities, putting the charities' interests directly at odds with those of the fisc. Accordingly, while I think charities should have a somewhat *greater* voice in the regulation of the sector, that voice should not be the dominant one. Because industry influence without industry control is also the premise of modified self-regulatory organizations like FINRA or the PCAOB, they provide appropriate models for comparison in incorporating elements of self-regulation into the federal charity regime.

IV. A PROPOSED PUBLIC/PRIVATE REGULATOR FOR CHARITIES: THE CHARITIES OVERSIGHT BOARD

Obviously, there is no one correct way to structure a public/private charity self-regulation body. However, for purposes of discussion, I would like to sketch my preferred version of such a regulator, the Charity Oversight Board, which would combine elements of both the PCAOB and FINRA.

A. Mandatory Membership.

Section 501(c)(3) would be amended to require as part of the "operational test" that an organization be at all times a member in good standing of the COB. The "organizational test" could require the organization's governing document to state that it will abide by the COB's rules. An organization would be subject to tax for any period in which membership was denied or suspended. Section 508's requirement of prompt application to the IRS for exempt status could be changed to require prompt application for membership in the COB.

Compulsory membership has three key advantages. First, because there is only one self-regulatory organization, it need not outcompete other regulators to attract charities into its organization. Thus, it helps to avoid the "race to the bottom" that could occur if there were multiple SROs. Second, it helps to ensure that the organization's elected governors are elected by, and accountable to, the sector as a whole, not just those interested in self-regulation. Third, if the self-regulatory regime is not all-inclusive, then the IRS must continue to shoulder the front-line enforcement responsibility for charities not electing to be governed by COB, creating inconsistencies in treatment and requiring the IRS and the COB both to maintain duplicative enforcement wings. For instance, with a mandatory COB, it would be possible for the COB to take responsibility for handling all Form 1023s in the first instance; if membership in COB is optional, then the IRS must also continue to process those forms for those charities opting out of the COB system.

B. Public/Private Hybrid Governance

I propose a board structure divided evenly into three parts—seven sector representatives elected by the membership, seven governmental representatives appointed by the IRS or Treasury, and seven independent "public directors" appointed by the COB Board and not directly affiliated with members of the sector or the government. The rules governing the selection of sector representatives could allow particular classes of charities—e.g., health care organizations, universities, private foundations, community foundations, churches, educational advocacy organizations, and small organizations (unless it is determined that churches should be exempted COB participation out of First Amendment concerns) each to vote in the election of a director

who would represent their interests on the COB. The rules governing the governmental representatives could require two or three key IRS or Treasury officials to sit on the board themselves; other representatives could be appointed by Congressional leaders, and the Board could also include representatives of state charity regulators.⁷⁹ Independent directors might include prominent public figures and legal experts in the field of charitable law; they might also include someone who would represent the interests of donors in the charitable sector. The COB would have a nominating committee also equally divided between government, sector, and independent directors.

Obviously, seven sector representatives are not nearly enough to provide representation to all of the different kinds of organizations in the U.S. charitable sector today. To deepen the COB's ability to take into account a broader range of perspectives, it would rely heavily on committees with responsibility for specific areas of charity law such as the private foundation rules or the limits on lobbying and electoral activity. These committees would typically include governmental and sector members of the COB Board of Directors, but also other sector representatives with more focused experience in the matters under consideration. All recommendations by such committees would need to be approved by the COB, which could also modify their proposals. (This structure would not be unlike the structure of the Panel on the Nonprofit Sector, which relied on several topical-area working groups to make recommendations that were ultimately reviewed by the full Panel.) The COB could also convene special advisory groups as necessary to deal with particular issues. As in the case of PCAOB, the COB could be required to consider proposals originating in its committees and would normally submit its proposed rule changes to the appropriate committees for comment.

The proposed balance between government and sector representation would ensure that both the IRS and representatives of the sector had the chance to consider rules for the sector together. Neither would have a controlling vote, but the IRS power to amend the COB's rules would force the other elements of the Board to take its views seriously.

C. Membership Rights

In addition to having some representation on the COB Board, members would have direct rights to approve Bylaw changes. Through a petition signed by a certain number of members, they could propose rule or Bylaw changes or alternate nominees for the board of directors.

D. Carefully Defined Scope of Rulemaking Powers.

The COB's rules, like those of FINRA, would not technically be law, and the IRS, like the SEC, would not have authority to enforce those rules directly except perhaps in extreme cases of COB enforcement failures. However, compliance with them would effectively be required as a condition of exempt status, since failure to maintain good standing with the organization would terminate an organization's exempt status.

The COB would have power to make rules necessary to ensure that its members comply with the federal tax standards, but would not have the broad mandate of the PCAOB to impose any other rules it believed were in the public interest. One of the advantages some commentators have seen in securities self-regulation is that the SROs can impose ethics or governance rules—or any other rules reasonably related to the purposes of the SROs—whereas the SEC or IRS

⁷⁹ This structure depends critically on the COB's status as a private self-regulatory organization; if the COB were determined to be a federal agency, the Appointments Clause would prohibit Congressional leaders from making appointments to it.

would be limited to making rules that can be understood as interpretations or implementations of the statute. Of all the advantages of self-regulation, I have the most doubts about this one, at least in the context of charity regulation. On the one hand, I am sympathetic to the occasional desirability of governance or disclosure rules on organizations not strictly required by the statute or the regulations. On the other hand, giving the COB *carte blanche* to impose its vision of what rules are best for the welfare of the sector is troubling because it effectively lends the force of federal law to norms fixed by a body with only limited democratic accountability. Furthermore, because COB rules are subject to IRS amendment, this would effectively allow a federally created entity to assume the general police power with respect to the operation of charities, invading the traditional sphere of the states. And even putting these federalism concerns aside, it is important to protect freedom of association and the independence of the charitable sector; allowing any regulator, even a self-regulatory body, to enforce its vision of proper charitable operations could smother the diversity of the sector.

For these reasons, I believe that the COB should focus on enforcing, and where necessary, interpreting, the core requirements of the federal tax law. If it is given authority to impose prophylactic rules, governance rules, or best practice standards, the areas in which that authority exists should be sharply circumscribed. For instance, the COB might be given power to enforce the private inurement standard and to impose those governance requirements that it determines will have a direct and substantial impact on compliance with the private inurement standard. It might be given somewhat broader discretion to determine what disclosures it will require and when. But it should not have anything like the PCAOB's broad mandate to impose whatever rules it thinks will be for the benefit of the public.

E. IRS Authority to Approve and Supersede COB Rules

The IRS would have the same authority to approve and/or amend COB rules after notice and comment that the SEC has with respect to both FINRA and the PCAOB. However, the IRS would have to reject COB proposed rules within a fixed time or it would be deemed to accept them, and rejections would be reviewable in court for abuse of discretion. Moreover, if the IRS approved a COB rule, it would thereafter be precluded from taking the position that the rule was inconsistent with section 501(c)(3). For instance, if the COB passed a rule stating that its members could link to websites of political candidates so long as they did not explicitly endorse those candidates, the IRS would have to repeal that rule or thereafter be estopped from arguing that such links constitute campaign intervention.

Thus, while the IRS would ultimately remain in control of the law governing tax exemption, the COB would effectively be able to force the Service's hand—the Service could not simply keep silent on clarifications made by COB rules. This would be an improvement particularly in areas of First Amendment concern like the ban on political campaign intervention, where IRS silence, coupled with the cost of tax-exempt status, can exert a substantial chilling effect. Furthermore, in practice one hopes that COB decisions would already be the result of compromise between the IRS and the sector, so that the IRS would only rarely intervene in the COB rulemaking process.

F. Enforcement Arm Governance and Procedure

The COB would have a large enforcement arm and a separate quasi-judicial arm, in which the sector would have somewhat less influence than it has in the rulemaking process. The boards of these separate arms (which could be separately incorporated subsidiaries) could consist in a majority of independent directors and a minority of government directors. Sector

representatives on the COB Board could have some influence over the composition of these enforcement and adjudicatory boards by selecting a minority of the independent directors, but no sector representatives would be allowed to sit on those boards themselves or otherwise participate in setting enforcement priorities, thus avoiding conflicts that would exist if charities had power to set their regulator's enforcement priorities.

The COB enforcement arm would have the power to audit and investigate member organizations and to demand the production of testimony or evidence. If it found violations of COB rules or of the law and regulations governing 501(c)(3) organizations, it would present the evidence of those violations to an administrative law judge in the COB's adjudicatory body, who would have power (after a hearing) to impose sanctions ranging from censure to fines to suspension or termination of a charity's membership. Any sanctions imposed could be appealed to the IRS and ultimately in court. In addition, the COB would forward its findings to the IRS, which could then assess any excise tax or penalties using its standard procedures.

It would be possible to structure the COB so that it could also impose sanctions on misbehaving charity managers or charity advisors. Charity managers and advisors could be required to join separate membership classes for charitable fiduciaries or advisors. As members of the COB, such individuals could then be subjected to fines for the violation of COB rules themselves. If this approach would be too burdensome on charitable directors (who largely serve on a volunteer basis), the COB could simply refer such individuals to the IRS, which could then impose any applicable excise taxes itself.

G. Transparency

COB finances, business affairs, and rulemaking processes would be public. Regular audits could be conducted by the General Accounting Office or the Treasury Inspector General for Tax Administration. Certain enforcement proceedings could even be open to the public, to ensure full disclosure to potential contributors and to deter other tax-exempt organizations from similar conduct.

Generally, COB enforcement proceedings would be at least as open as those of the PCAOB, and probably somewhat more public. While documents obtained under PCAOB investigatory powers must generally be kept confidential, they may be shared with other federal and state government officials.⁸⁰ Furthermore, the PCAOB publishes reports setting forth the findings of its regular inspections, although it does not publish findings of defective quality control systems, if those defects are adequately addressed within 12 months.⁸¹ Disciplinary hearings are normally kept private, but if the PCAOB imposes sanctions against any person, that sanction is reported to the SEC, state regulators, and (once any stay during appeal to the SEC has been lifted) to the public.⁸²

Like the PCAOB, the COB would be free to share information with other regulators and would publish the results of its audits, perhaps with a grace period to cure any negative findings. In addition, because the government subsidy of the tax-exempt sector favors somewhat greater transparency than is appropriate for for-profit accounting companies, I would argue that whenever the COB enforcement arm finds enough evidence to open a disciplinary hearing, that

⁸⁰ Sarbanes-Oxley Act, § 105(b)(5)(B).

⁸¹ *Id.* § 104(g)(2).

⁸² *Id.* § 105(d).

hearing should be public as well (with due provision for protecting an organization's membership lists or similar confidential information). Generally, it is public knowledge when someone is tried for a crime, even if the person is ultimately acquitted. I see no reason for more secrecy with respect to charities, particularly given the fact that the public may donate funds to them in reliance on their charitable status.

The COB could operate an informational service to provide donors with information about the charities it regulates. For example, the NASD operates the BrokerCheck program that enables the general public to access information about the professional background, business practices, and disciplinary history of NASD-registered firms and brokers.⁸³ The BrokerCheck system receives over 2.4 million requests per year and according to the NASD website, responds to “most within minutes.”

Finally, I envision that the COB could fund investigative positions in state charity regulatory offices in much the same way that the Medicaid Fraud Control Units are funded, using either separate Congressional appropriations or a portion of the funds collected by the COB. The COB could also serve as a coordination and training resource for state regulators.

H. Real-time Enforcement Efforts

Unlike the IRS, the COB would not be tied to the annual return and audit system as its primary method for policing charities. Instead, it would be free to develop enforcement mechanisms designed to identify problems as they arise. For instance, the COB could require its members to provide it with 20 days' notice in advance of consummating certain transactions, much as some state nonprofit statutes require notice to the attorney general.⁸⁴ Examples of reportable transactions might include the following:

- Dissolutions, mergers, and other substantial dispositions of assets
- Transactions with disqualified persons above some threshold amount
- Investments in closely-held businesses representing a significant stake in the business or a significant portion of the charity's assets
- In-kind donations with a claimed value above a threshold amount

The COB could review incoming notices for potentially improper transactions, making further investigation when necessary. It could also publicize the disclosed transactions, making such disclosure statements available online the same way the SEC makes various SEC filings available to the public. This disclosure would itself encourage many organizations to avoid borderline transactions with insiders or donors. Organizations that failed to provide notice as required would be subject to sanctions even if the transactions they failed to report did not violate the COB's rules or the federal tax rules.

Other investigations could be initiated as soon as the COB learned of a potential violation. In some cases, that would require waiting until after the end of a year—for instance, whether an organization's lobbying is substantial must be considered in light of at least one year's activities. But in many cases, the COB could launch an investigation within days of seeing a significant transaction appear in the news.

⁸³ This system is required by 15 U.S.C. § 78o-3(i)

⁸⁴ See, e.g., Revised Model Nonprofit Corp. Act §§ 11.02(b), 14.03; Cal. Probate Code § 17203(c).

Periodic reporting of basic information about the organization could also be improved by severing the link between such information reporting and the filing mechanisms and protocols for other returns. Indeed, an electronic filing system independent of the other IRS tax return filing systems was developed by the National Association of State Charity Officials and the Urban Institute with less cost and well before the IRS system was put in place. Quarterly public financial statements could be required for tax-exempt organizations based on income or asset level, much as required from publicly traded corporations. Besides providing more up-to-date information for the public, this would allow the COB to identify questionable activity within months, rather than years.

I. Funding

The COB would be funded largely by member dues, which could be set on a sliding scale based on asset size or gross receipts or a combination of the two. The IRS would be able to review the COB schedule of dues and fees. Unlike the current section 4940 tax, which applies only to private foundations, the COB membership assessment would be made against all charities, on the theory that all of the recipients of the tax subsidy accorded to section 501(c)(3) organizations should share in bearing its regulatory cost. Because the section 4940 tax was originally meant to fund greater charitable enforcement, dues paid to the COB should be credited against the 4940 tax—but I would not insist on this if the resulting revenue costs made the COB difficult to pass under pay-as-you-go principles. Given the large disparity between the annual budget of the Exempt Organizations Division and the amount of 4940 tax collected, dues payments could be set at a tiny fraction of assets and still result in a budget many times the size of the current Exempt Organizations budget.⁸⁵

The COB could also charge user fees for handling new membership applications (its analogue of the Form 1023) and for other services. Note that the IRS reports that it currently processes more than 60,000 applications for 501(c)(3) status each year.⁸⁶ Conservatively assuming that only half of the filing entities pay the standard \$500 user fee, the new membership user fees alone would generate over \$15,000,000 annually.

Other fees might be charged in connection with transactions requiring heightened review. For instance, if an organization accepted a contribution of in-kind property with a claimed value of \$500,000 or more, current IRS rules require an appraisal to be attached to the return claiming the deduction.⁸⁷ The COB could require a copy of the appraisal at the time of the gift, and charge a fee of \$5,000 to \$10,000—a fraction of the donor's likely tax savings—to defray the costs of hiring an appraiser to review the donor's appraisal. Similar fees might be imposed for transactions with insiders requiring review. Such transaction-specific fees would promote equity by ensuring that those engaging in transactions requiring a greater degree of oversight bore a greater portion of the costs of that oversight.

Fees could also be charged for services to the general public. For instance, for a small fee the organization could provide access to a searchable database of complaints filed against charities or their fiduciaries to determine if any problems had been reported for a particular charity.

⁸⁵ According to IRS Data, in 2004 total charitable assets reported on Form 990 and Form 990-PF was approximately \$1.7 trillion. A dues payment equal to 0.02% of assets, therefore, would generate \$340 million—likely more than quadrupling the EO Division's current budget.

⁸⁶ 2011 I.R.S. Data Book, 51, 55 tbl.24.

J. Private Entity Status

As an organization not controlled or funded by the federal government, the COB, like FINRA, should be free from various constraints that apply to the operations of government agencies. Its enabling statute could explicitly exempt it from the Civil Service rules of Title 5. Its directors would not need to be appointed as specified in the Appointments Clause, it would not be subject to the Fifth Amendment. Of course, because courts have found the NASD to be a private entity in part because it was not specifically created by statute and received *no* government funding and included *no* government officers on its board,⁸⁸ the case for the COB's private status is not quite as strong as it is for FINRA, so it is possible that the courts would eventually hold it subject to some of these constitutional constraints.

K. Secondary Functions

Like FINRA, the COB could devote a portion of its budget to providing outreach to new charities and their managers and generating educational materials explaining charitable standards. It could also spend some of its funds to collect data about the activities, characteristics, and needs of its members. To the extent that it identified widespread needs for particular services that it could effectively fill, it could devote resources to providing such services.

V. ADVANTAGES OF THE PROPOSED CHARITY OVERSIGHT BOARD

The proposed Charity Oversight Board would resolve many of the concerns with the current IRS Structure:

- The fee-based funding mechanism would sever the link between charity enforcement and the appropriations cycle, ameliorating the chronic underfunding that has stymied charity regulation to date.
- The combination of sector, government, and independent directors, together with the oversight of the IRS, would provide the sector with a voice in setting the agenda and content of regulation, while ensuring that the COB would not be captured by the regulated community.
- With its own dedicated regulatory entity, charity enforcement and guidance would no longer have to compete for attention and resources with larger tax collection priorities.
- Because the organization's funding stream would be related to the overall financial health of the sector as reflected in the total asset size or gross receipts received of the organizations it regulates, the oversight agency would be attuned to watch for any unintended adverse effects of its rule-making, thus helping to ensure rules specifically targeted at problems and concerns.

⁸⁸ See, e.g., *Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc.*, 191 F.3d 198, 206 (2d Cir. 1999).

- As a private entity, the COB would not be subject to the privacy rules in section 6103 and their limited exceptions in section 6104. It could therefore permit greater disclosure of enforcement actions in a manner analogous to the publication of NASD enforcement actions.
- The current privacy structure in the Internal Revenue Code that prevents information-sharing and collaboration between the IRS and state regulators would no longer prevent coordination and could reduce arbitrage planning around inconsistent or nonexistent enforcement at the federal and state level.
- The COB would be more transparent because records of its operations, rulemaking proceedings, audits, and disciplinary actions would be made public, together with its finances and other operations.
- As a private sector entity, the organization could be freed from the idiosyncratic limitations inherent in using systems and procedures developed to administer the tax-collecting provisions of the Internal Revenue Code, with reporting deadlines designed to ensure that up-to-date information about the charity and transactions of interest are promptly made available to the public and available for regulatory review.
- As a private organization, the oversight group would be able to pay true market-rate compensation and recruit based on its needs, rather than on federal budgeting cycles. Setting staffing at levels dictated by the workload could greatly reduce delays in the issuance of rulings or other interpretative opinions, providing enhanced and timely assurance to the regulated community, and, as a result, abuses or other concerns could be more quickly addressed.
- A stable funding source and independence from federal contracting requirements would permit the implementation of state-of-the-art support systems not currently attainable within the IRS structure and mission.
- It is worth stressing that many of these advantages would exist regardless of the precise structure chosen for the new public/private regulator. And while I favor starting with a limited mandate for such a regulator, its structure could also lend itself to more ambitious goals:
- The oversight entity could be empowered to promulgate rules applicable to all tax-exempt entities, not just charities.
- As a private body whose authority would not have to flow exclusively from the Internal Revenue Code, the oversight group could regulate conduct in a broader way, much like a state attorney general. Indeed, its board could easily be configured to include more substantial representation of state attorneys general, and it could undertake to enforce state law rules regarding charitable solicitations and ensuring that charities use donations in accordance with donor intent. Subject

to review by the relevant state attorney general, it could be empowered to enforce the provisions of charitable trust and other state laws.

- The COB would not always have to impose uniform standards on all charities. In some cases it could simply serve as an enforcement body for standards voluntarily adopted by individual charities or groups of charities. All too often, voluntarily adopted policies have little practical effect because there is no mechanism for enforcing the policies. If charities could adopt policies that made sense for their particular circumstances and easily opt to make those policies enforceable by the COB, they would be able to assure the public that their policies would actually be followed.

CONCLUSIONS

Moving to an alternative regulatory model will require significant statutory changes, and while such changes do not occur frequently in federal tax law, the advantages and opportunities of a privatized oversight mechanism along the lines of the NASD seem clear. The advantages of maintaining the current system seem unclear at best. The current environment provides a window of opportunity to consider a proposal like the preceding. Recently, the House Ways and Means Committee has been focused on the sector, and in particular on whether the PPA was a step in the right direction in terms of regulating charities. Over the past several years, state legislatures and Attorneys General have contemplated the adoption of regimes modeled on the Sarbanes-Oxley rules for for-profit corporations. Thus, the future of the current array of the federal and state rules is uncertain. With the spotlight on the inefficient, inadequately funded structure in place, those interested in strengthening the sector's health and welfare should seize the moment to advance the dialogue to the next level. Certainly, the creation of a new oversight entity will provide the opportunity to address the inefficiencies and anomalies that have been exposed by 35 years of experience with the current system.