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Foundations Must Stop Passive Approach

By Lucy Bernholz

Imagine this: You are a leader in a multibillion-dollar industry that has experienced several years of unprecedented growth. Over the course of the last three years, however, the news media has taken every opportunity to expose scandal in your ranks, the pace of growth has slowed significantly, regulators and legislators are panting at the chance to enact real change in how the industry works, and new competitors are popping up on all sides. While the newcomers are much smaller than the current industry leaders, many of them are financed by huge established institutions with lots of research-and-development capacity and deep pockets.

Sound like high tech or the music industry? Try again. This is philanthropy today.

The constellation of players within philanthropy exploded both in size and structural diversity during the 1990s. Commercial players like Vanguard and Schwab now offer donor-advised funds, and Fidelity Investments and Foundation Source provide full-fledged foundation-management services. Foundations are only small players in a complex industry that includes financial-services firms, investment banks, private advisory services, and several Internet-based systems and tools.

The only thing about this picture that should surprise anyone who has been paying attention over the last few years is how meek the industry's reactions to these changes have been. And, anything that has been done has been done as a reaction.

Philanthropic leaders have been slow to promote proposals to foster the ethical, credible, and valuable application of billions of dollars. No coalitions exist to present solutions or lead industry efforts to promote self-regulation, garner news-media support, or push for regulatory changes to increase investment in the industry.

What is remarkable about the industry's approach to regulation -- generally summarized as fear and loathing -- and its defensiveness is that this attitude continues relatively unabated even though the environment for philanthropy has changed substantially.

Grant makers are profoundly unprepared to use regulation as a tool to further their own missions, even though the banks and insurance companies that have entered the field are masters at shaping regulation to their benefit.

Institutional philanthropy in the 21st century should be seeking ways to examine how it can be a stronger partner in working with government, pushing for legislation and regulation that encourages donors to expand their philanthropy, and building ways for donors to obtain credible guidance in the marketplace as competition continues to increase.

Promoting appropriate regulatory oversight will confirm the industry's commitment to the accountable use of tax-exempt resources. It can build confidence in the field by demonstrating enviable corporate oversight, public disclosure, and freedom from conflicts of interest. Philanthropy can take a leadership role in collaborating with government or business to promote high standards of practices and work with oversight agencies to enforce those standards.

Perhaps most important, the industry needs to promote more-deliberate regulatory action to ensure that it continues to be defined primarily by its social contributions and not by its role within the financial-services marketplace.

Today's government regulations do little to promote effective philanthropy, a point that foundations should be making clear to policy makers. The 1969 Tax Reform Act laid the groundwork for public reporting of basic financial and grant information, but with billions of philanthropic dollars now in play, government regulation should focus on the results of what is done with philanthropic funds. Regulation of philanthropy should reward the organizations and donors that do the most to solve problems, share expertise, and align their resources so that they have the greatest impact possible.

Philanthropy is a unique industry in that it -- alone among financial-service industries -- stands to achieve its stated goals only if its members share information, confer on strategy, pool financial resources, jointly invest in human capital, and build systems for efficiently aligning their individual actions. That is because no single individual or grant-making organization has the financial resources to achieve its stated social goals.

Although the individual entities are set for failure, the industry as a whole invests hundreds of billions of dollars annually in activities dedicated to the public good. If philanthropic resources can be aggregated even in small ways toward common goals, they can be substantial contributors to achieving those goals.

If elements of the industry were deliberately designed, streamlined, creatively conjoined, and aggregated, we could indeed build new philanthropic capital markets that could significantly improve the quality of community life. For instance, incentives could be added to the tax code to allow donors more-generous deductions when they pool funds, collaborate on issues, or share information in ways that reduce overall administrative costs and result in more dollars to charitable efforts.

Governments could also take steps to encourage more grant makers to share their expertise with others so that new donors would not keep repeating mistakes and would have opportunities to learn where their investments could do the most good. Society would benefit from a regulatory structure that rewards those who contribute knowledge to the philanthropic marketplace.

For example, the federal government could reduce the excise tax (which private foundations must pay on their net investment assets) for grant makers that support an exchange of knowledge. Or foundations that provided due diligence on potential grantees and research support for grant makers with like interests could be given the freedom to spend proportionately more on their administrative costs than foundations that don't make contributions that improve the overall effectiveness of philanthropy.

While philanthropy is a creative act that is more likely to respond to carrots than sticks, foundations and others would be wise to encourage government regulation to enact penalties on anybody or any organization that misleads philanthropists.

The lack of regulations or credentials for philanthropic advisers is a scandal waiting to happen. We have already seen scandals involving the management of charitable assets and situations where foundations pay more to their board members to manage the money than they give to nonprofit groups. We will no doubt soon see a violation where a consulting firm, advisory service, or independent ratings group was in fact funneling philanthropic resources to its own purposes or providing a front for some kind of criminal activity.

Market forces will play a significant role in weeding out ne'er-do-well and inept service providers, but the market is too big and the providers so small that it may take a long time for a scam to rise to the necessary level of attention for the market to stop it. What do philanthropic program advisers need to know? How do program advisers relate to accountants, investment managers, and lawyers, all of whom serve the philanthropy market and are (at least to some degree) regulated by professional standards and monitoring bodies?

Voters, even those who are donors, are unlikely to ever devote a lot of energy to encouraging regulations that stimulate a robust philanthropic industry. That is why it is up to philanthropy's leaders to do the job.

But who will lead the battle? Most of the players in philanthropy are small; it is a big industry of mostly mom-and-pop shops. It is difficult for individual donors and most foundations to find one another in a crowded landscape and to work together.

The individual approaches of foundations and the competitive aspect of the changing market exacerbate the fragmentation in the industry. Just as the time to come together and build alliances and joint ventures is so clearly upon us, the forces at work in industry growth are pulling institutions apart.

The prominent foundations -- those recognized most often for the size of their endowments -- are extremely privileged players in this industry that rarely act on its behalf. In the current landscape, these organizations benefit not only from their permanence, but also from their experience, stability, professional expertise, and unique view of the rest of the industry.

Unlike the few other industry participants that pay attention to trends, market research, and industrywide challenges and opportunities, these large endowed foundations are not seeking to profit off the market; rather, they genuinely profess to care about the industry's well-being. These foundations face two issues in exerting leadership.

First, they have little experience with actually working together and speaking on behalf of the industry. Whereas other industries retain such assistance and are ready to mobilize on a moment's notice, organized philanthropy moved so slowly to this cause that it was national news when a group of wealthy foundations finally hired a former congressman to make their case during last year's debate over a House bill that would have effectively forced foundations to give more annually.

Second, foundations have spent most of their efforts attempting to differentiate themselves from the other players in the industry even as the importance of those differences decreases.

The lines between government, business, and nonprofit groups are blurred now in ways perhaps not seen since the American colonies first formed. Generations X, Y, and beyond are used to commercial operators of public schools, church-based ecumenical soup kitchens, nonprofit providers of health-care and other employee benefits, and alcohol companies underwriting everything from athletic events to art exhibitions. These generations are unfazed by the sight of federal agents, local police officers, and private contractors working together to screen bags at airports.

In these contexts of shifting roles and expectations for government and business, the unique role of nonprofit groups and philanthropists is even harder to articulate. And the nonprofit world's pattern of trying to focus on its uniqueness, rather than its contributions in partnership with the others, raises more questions than it answers.

Notwithstanding such challenges, philanthropy should seize the opportunity to promote a regulatory structure that encourages effective giving. Otherwise, it could find itself dealing with rules that stifle, rather than stimulate, giving to causes that promote the common good.

Lucy Bernholz is founder and president of Blueprint Research and Design, a San Francisco consulting company that helps foundations develop grant-making programs. This article is adapted from her book, Creating Philanthropic Capital Markets: the Deliberate Evolution (John Wiley & Sons).

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