

July 26, 2011

Thomas R. Calcagni
Acting Director
Division of Consumer Affairs
Post Office. Box 45027
Newark, New Jersey 07101

Re: **Rule Proposal Volume 43, Issue 11 (June 6, 2011)**

Dear Mr. Calcagni:

The New Jersey Division of Consumer Affairs Charitable Registration Unit has requested comments on a proposal that would amend N.J.A.C. 13:48-11.2 to require certain disclosures by charities soliciting funds in New Jersey. This letter serves as my comment.

This proposal, as well intentioned as it might be, demonstrates a pervasive problem with rulemaking and the law: Too many proposed laws and regulations address problems that either don't exist or don't need to be solved through another rule.

THE PROPOSAL. Under the New Jersey proposal, a charity that that conducts two or more programs and solicits funds through a solicitation that mentions more than one of those programs would be required to tell donors that they have the option to designate how the funds are allocated among the programs. As currently written and as described in explanatory comments, the proposed regulation would prevent the charity from using any portion of an earmarked contribution for administration or fundraising expenses when a donor decides to earmark funds for a specific program. I arrive at this interpretation because there is a second provision providing that the notice provided to donors must also state that if a contribution is not earmarked for one or more programs, then the money can be used for any program "in furtherance of the organization's mission and for administrative and fundraising expenses." By negative implication, this language means earmarked money cannot be used for administrative and fundraising expenses. The explanatory comment accompanying the proposal supports that interpretation, asking whether the final rule should permit a recovery of some overhead from a contribution otherwise earmarked for a particular program.

THE THREE FALLACIES UNDERLYING THE PROPOSAL. There are at least three major fallacies underlying this proposal. The first fallacy: Donors don't already have the right to

earmark their funds. In fact, donors always have the right to designate that their donations be used for a particular purpose. So why do we need a rule that will require a charity to develop or expand systems to track the inevitable designations that will be made once earmarking becomes the default rule, particularly when this rule is aimed at what I refer to as retail contributions? This is just another example of government adding a cost to doing business without any meaningful benefit derived from that cost.

The second fallacy: Charities belong to the public and therefore New Jersey has an interest in dictating how they operate. In fact, charities are private entities, no different than IBM, Exxon, or General Electric except for the fact they cannot distribute net earnings to private interests. Charities should be free to enter into any type of voluntary contractual arrangement that they like without the state interfering. As noted, the parties to a charitable contribution already have the right to negotiate how the funds will be used. This proposal interferes with the charity's right to make an offer: "Give us money and we will use it for our mission." Now the charity must add additional terms to its offer. Instead of placing the burden on charities, why doesn't the proposal require donors to think before they give?

The third fallacy: This is the most important fallacy: Program service expenses are good, but administration and fundraising expenses are bad. Any thinking person cannot and should not distinguish between program service and other expenses. It is impossible to draw that distinction and it is meaningless. Charities need accountants, HR people, and marketers to deliver human, health, educational or cultural services just as much as they need doctors, drug counselors, teachers, and curators.

No regulator would be pleased if a food bank simply left a bag of money on its doorstep and said take what you need to buy food. Without security measures, the money would most likely be stolen. Without qualification measures, some people who can afford food would take the money believing they were the intended beneficiaries. Without people to disburse the money, some people in need of food would take more money than they should, leaving other people in need hungry. There is an important place for administration.

As for fundraising expenses, why should the charity or other donors bear the burden? Any donor can eliminate all mailing costs and telemarketer fees with minimal effort. Send a check to the charity. Fundraising costs are necessary because the public is passive (lazy). I regularly send our family's contributions directly to the charities we have chosen to support, knowing that this reduces fundraising costs and maximizes the amount of our dollars that does go to mission. Why should our family's contributions bear a disproportionate share of fundraising expenses when we were the ones who acted in a manner to minimize those costs? The New Jersey proposal creates a free-rider problem.

THE PROPOSAL TO DIVERT FUNDS FROM OVERHEAD IS INCONSISTENT WITH CURRENT POLICIES AND PRACTICES. State charity regulators are screaming that many charities are poorly governed and rightfully so. So what do they do? For the last decade, they, together with the IRS and many others, have been prodding charities to improve governance, internal controls, and systems. Be more business-like. Sarbanes-Oxley and all that.

Audits, board training, more frequent board meetings, compensation studies, the infrastructure to support whistleblowers, better accounting systems, and governance consultants all cost money--administrative expenses. But when it comes to funding those expenses, the State of New Jersey suddenly proposes a regulation suggesting that governance has no value. Governance is financed by administrative expenses, but without good governance, money designated for program services may be lost or stolen, or used in a less than efficient manner.

In terms of standard or accepted practices, the New Jersey proposal runs counter to standard grantmaking practices. Universities regularly require faculty members who receive grants to contribute a percentage of each grant to general operations, recognizing that a research lab cannot exist without campus security, student admissions, and heat and light. The same holds true for charitable organizations receiving federal funding. The Office of Management and Budget regulations governing government grants and contracts contain elaborate procedures to determine the amount of organizational overhead that is eligible for reimbursement with federal funds.

No charity would be financially viable if all its funders required that none of their funds could be used to cover overhead--or at least the charity would have to develop ridiculously complex cost allocation rules to convert every dollar of overhead into a program expense through cost allocations. Yet, that appears to be the direction in which New Jersey wants to take charities. When charities respond to the New Jersey proposal by adopting such complex formulas, will the New Jersey regulators challenge those attempts to convert overhead into program service expenses? The proposal raises nearly impossible line drawing issues, but offers absolutely no insight into how those lines are to be drawn.

To bring home the point of just how misguided the New Jersey proposal is, I can make a strong case that any board that permits a donor to earmark funds for "pure" program expenses has breached its fiduciary duty. Doing so weakens the charity's financial capacity by failing to cover what are very real costs. Yet that is exactly what New Jersey is mandating.

THE PROPOSAL UNDERCUTS THE BOARD'S FUNDAMENTAL ROLE. The New Jersey proposal also undercuts the role played by the charity's board of directors. The law looks to boards to allocate resources because the board has information that the public doesn't necessarily

have. Moreover, a board has the bigger picture in mind. To illustrate: Let's assume a charity has three distinct programs. The board has allocated 75% of resources to Program A, 20% to Program B, and 5% to Program C. Its fundraising materials refer to all three programs. Now we put the New Jersey proposal into effect.

Assume there is a tragedy that occurs and the hypothetical charity receives massive amounts of media attention. Program C has the most relevance to assuring that similar tragedies don't occur. No one should be surprised that if offered the choice, the public, receiving the solicitations immediately following the tragedy, will designate that all their contributions go to Program C. Does the charity then close down the two larger programs, recognizing that a year from now, when the story is no longer front and center, that people will probably not designate money for Program C?

I am not suggesting that charities should deceive the public. If they specifically solicit for Program C or people designate Program C, the charity should honor that designation. But why is New Jersey showing a preference for restricted rather than unrestricted money? Goodness knows, there is plenty of evidence that would more than justify outlawing donor-restricted contributions. Recent controversies involving Fisk University, the Hershey Trust, Princeton University, Brandeis University, and the Barnes Foundation demonstrate the problems that donor-imposed restrictions can create. New Jersey is proposing to expand those problems by making restricted giving a way of life for retail donors.

In fact, a good case can be made that unrestricted money should be preferred to restricted money. Unrestricted money permits the board to be more responsive as facts, circumstances, and needs change. Organizations that are tasked to solve problems need the flexibility to refocus programs as better approaches to accomplishing mission become apparent.

ENFORCEMENT IS THE WAY TO ADDRESS THE CONCERNS UNDERLYING THE PROPOSAL. I suspect that this proposal comes from regulator frustration with admittedly sleazy organizations that routinely solicit from the public, with 85% to 90% of the amounts raised being used to line the pockets of insiders. The tail wagging the dog, so to speak. The proposal assumes that tighter regulation will stop these practices. Experience teaches that the sleazy operators find ways around these efforts to stop them, while legitimate charities pay the price that comes with increased regulatory burden. Sadly, enforcement actions are expensive, but they are the only way to stop the unscrupulous operators. This is particularly true from a cost-benefit standpoint.

If a charity raises money for the arts and then funds health care, the New Jersey regulators should bring an enforcement action. If a donor gives money for X and the charity accepts it with that restriction and then does Y, the New Jersey regulators should bring an enforcement action. If someone lies about the percentage of funds used for

fundraising or the charity is operated for the primary benefit of insiders, the New Jersey regulators should bring an enforcement action. But the New Jersey regulators should not develop rules that favor restricted money over unrestricted money.

This is another case where consumers have the power to protect themselves. By unnecessarily showing a preference for restricted giving, the New Jersey regulators are creating problems for charities and substituting imagined donor-intent for the board's considered judgment. Consumers have duties, too. By bending over backwards to protect consumers, the New Jersey regulators encourages consumers to be lazy to the detriment of charities and the missions they serve.

Having issued a proposal that I view as ill-conceived, the New Jersey regulators should now follow the example set by the IRS. In the original draft of the recently redesigned Form 990, the IRS proposed highlighting fundraising ratios on the first page of the return, thereby trying to draw a meaningless distinction between program service and other expenses. Following overwhelming opposition, the IRS dropped what it quickly realized was a bad idea. New Jersey should do the same.

Respectfully submitted,

Jack B. Siegel
Charity Governance Consulting LLC

BACKGROUND INFORMATION

I am an attorney (Illinois and Wisconsin) and CPA (Wisconsin), holding an LLM in Taxation from New York University and a Master's of Management from Northwestern University. I provide consulting services through Charity Governance Consulting LLC, with a focus on training, governance, financial management, and special projects.

I am the author of *A DESKTOP GUIDE FOR NONPROFIT DIRECTORS, OFFICERS, AND ADVISORS: AVOIDING TROUBLE WHILE DOING GOOD* (Wiley 2007), a 750-page book addressing the legal, financial, tax, and governance issues facing nonprofits. I just completed a three-year term as a member of the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT).

I am a frequent speaker at tax and nonprofit law conferences around the country, including NAAG-NASCO's annual conference. I have also taught seminars in Australia and Singapore. I also write the CharityGovernance blog (www.charitygovernance.com), which covers current developments in the nonprofit sector.

I have spoken on three occasions to fundraising groups, but do not recall ever being retained by a professional fundraiser.