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## MEMORANDUM

**TO:** [redacted]

**FROM:** Betsy Buchalter Adler and Thomas Silk

**DATE:** November 14, 2002

**RE:** U.S. Treasury's Proposed Voluntary Guidelines for U.S.-Based Charities

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In the aftermath of the September 2001 attacks on the U.S., the Department of the Treasury blocked the assets of three U.S.-based charities which Treasury determined to be linked to foreign terrorist organizations, specifically Al-Qaeda and Hamas. These actions were taken under Executive Order 13224, "Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism," and the USA Patriot Act.<sup>1</sup> On November 8, 2002, to allay concerns in the Arab-American and American Muslim communities that legitimate charitable institutions and their donors would be at risk, Treasury released a document entitled "U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: *Voluntary* Best Practices for U.S.-Based Charities" (the "Voluntary Guidelines").<sup>2</sup>

The press release accompanying the Voluntary Guidelines states that charities that implement the Guidelines effectively will achieve "a corresponding reduction in the likelihood of a blocking order against any such charity or donors who contribute to such charity in good faith, absent knowledge or intent to provide financing or support to terrorist organizations." The Voluntary Guidelines are far-reaching and are inconsistent in several respects with federal tax laws and state corporate laws governing charities. The press release notes that the Voluntary Guidelines are "consistent with the principles espoused in both the private and international public sectors," citing the Better Business Bureau, the Evangelical Council for Financial Accountability, and the Financial Action Task Force. The Treasury's issuance and adoption of the Voluntary Guidelines, however, lends them a far greater significance than the statements of self-appointed "watchdog" organizations. For this reason, we have prepared this summary of the Voluntary Guidelines for your review, together with our comments and analysis.

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<sup>1</sup> We attach a recent memo from the Council on Foundations, "International Grantmaking After September 11: Dealing With Executive Order 13224 and the USA Patriot Act," summarizing relevant provisions of those documents.

<sup>2</sup> The word "voluntary" is italicized on the cover page of the Voluntary Guidelines, though not in the text.

**Overview.** The Voluntary Guidelines address four topics: governance, disclosure and transparency in governance and finances, financial practice/accountability, and anti-terrorist financing procedures. They are presented as a series of statements about what the charity “should” do or refrain from doing. The Voluntary Guidelines do not indicate the source of these prescriptive statements, nor do they identify the authors of the document.

**Governance.** The Voluntary Guidelines state that a charity’s governing instruments – i.e. its Articles of Incorporation and Bylaws – should not only set forth the charity’s goals and its legal structure, but should also “set forth requirements concerning financial reporting, accountability, and practices for solicitation and distribution of funds” and “state that the charity shall comply with all applicable federal and state laws.” The Voluntary Guidelines then prescribe several very specific standards for the charity’s Board of Directors:

- ❑ **Size.** The charity’s board should have at least three members.
- ❑ **Frequency of meeting.** The board should meet at least three times a year, with a majority of directors attending in person.
- ❑ **Conflicts of interest.** The board should adopt a conflict of interest policy applicable to directors and employees. If a conflict exists, the charity should go no further: “The charity should not engage in transactions with entities in which a board member has a conflict of interest.”
- ❑ **Independent board.** The board should be independent. If more than 20% of the charity’s governing body, or more than 20% of its executive committee, is directly or indirectly compensated, the organization “will not be considered to have an independent governing body.”
- ❑ **Minutes.** The “records of all decisions made” by the board – i.e. the minutes of the meetings -- should be available for public inspection.

Comments. This section of the Voluntary Guidelines effectively states a federal corporate governance standard, which conflicts with the laws of many states governing non-profit corporations. The nonprofit corporate laws of the various states differ on the minimum number of board members, the minimum required number of board meetings, and the proportion of board members who may be compensated by the charity.<sup>3</sup> Adding to the confusion, the Voluntary Guidelines are couched in terms of corporate governance; some charities are organized as trusts rather than corporations, a legal form which does not lend itself to the practices described here. Most states allow a nonprofit board to act by a conference telephone meeting and by unanimous written consent, rather than requiring all or a majority of members to be physically present at all times. Finally, we are aware of no state which requires nonprofit corporations to make their minutes public as a matter of law.

The conflict of interest provisions, while well-intentioned, are troubling on multiple levels. The Voluntary Guidelines broadly proscribe any transactions involving a

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<sup>3</sup> For example, California is alone among the 50 states in requiring 51% of a nonprofit public benefit corporation’s governing body to consist of people who have not been compensated by the charity within the previous 12 months and, in addition, do not have a family member who has been so compensated.

conflict of interest on the part of a board member, but they do not define a conflict of interest. Suppose Charity A is considering a grant to Charity B, and a director of Charity A also serves on the board of Charity B. Does that constitute a conflict of interest which would prevent Charity A from approving the grant? Or do the Voluntary Guidelines only intend to ban conflicts of interest involving a material economic benefit? From the text, we cannot tell. In addition, the Voluntary Guidelines do not recognize the existence of Internal Revenue Code Section 4958 and the carefully drafted Regulations to that statute, which allow public charities to transact business with their insiders if the transaction is first approved, following full disclosure and appropriate inquiry, by the disinterested members of the governing body as being reasonable to the charity and not involving any excessive benefit to the insider. If a charity complies with the procedures specified by the Regulations to Section 4958, the transaction is presumed to be reasonable. If taken literally, however, the Voluntary Guidelines would effectively render Section 4958 void.

**Disclosure/Transparency in Governance and Finances.** The Voluntary Guidelines include some standards already imposed by IRS Form 990 and 990-PF – for example, making publicly available a list of the board members and the salaries they are paid, making publicly available similar information about the five highest-paid employees, maintaining records available to the board members of entities receiving funds from the charity, providing an “annual report” on request (presumably a copy of Form 990). However, they also state that the charity should “maintain records containing additional identifying information about its board members, such as home address, social security numbers, citizenship, etc.” The Voluntary Guidelines extend the public disclosure requirements to “any subsidiary or affiliate receiving funds from the charity” although they do not define “subsidiary or affiliate.” In addition, the Voluntary Guidelines state that the charity should provide complete annual financial statements on request.

The Voluntary Guidelines also address solicitations for funds. They state that a charity should state its purposes “so that anyone examining its disbursement of funds can determine whether a charity is adhering to those goals.” Solicitations should state how the donations will be spent. The charity “should substantiate on request that solicitations and informational materials, distributed by any means, are accurate, truthful, and not misleading in whole or in part.”

*Comments.* The portion of the Voluntary Guidelines dealing with identifying information raises privacy issues. An employer generally must record an employee’s social security number, home address, and citizenship status. However, we are aware of no law that requires a charity to maintain such information regarding anyone who is not compensated by the charity nor a recipient of aid from the charity, as the Guidelines suggest.

It is possible that the financial disclosure standards could be satisfied by providing a copy of IRS Form 990 or 990-PF on request, as federal law already requires charities to do. However, because the Voluntary Guidelines do not refer to these forms, it is not clear whether providing a copy of Form 990 would satisfy these requirements. Also, the failure to define “subsidiary or affiliate” means that charities desiring to comply with these standards may provide more or less information than Treasury believes is necessary.

Finally, the question of what charities must disclose in their fundraising solicitations has been before the Supreme Court in various forms over the years, most recently in oral arguments earlier this month. Treasury's endorsement of certain practices in the Voluntary Guidelines must be read in light of the Supreme Court's consistent rejection of state and municipal charitable solicitation ordinances on constitutional grounds.

**Financial Practice/Accountability.** The Voluntary Guidelines state that a charity whose total annual gross income exceeds \$250,000 should retain an independent CPA firm, selected by the charity's board, to audit the charity's finances and issue "a yearly audited financial statement, which should be available for public inspection." The charity should keep records of receipts and expenditures (including the name of each recipient and the amount paid) in accordance with generally accepted accounting principles and should promptly deposit all received funds into its bank account. The charity should not disburse cash grants but, rather, should disburse funds by check or wire transfer.

*Comments.* Most states do not require charities to be audited. It is not clear why audited financial statements should be required or disclosed when Form 990/990-PF is already a matter of public record and available on request. Also, while most would agree that checks and wire transfers are generally preferable, there are two circumstances in which cash disbursements may be the most prudent form: urgent disaster relief in parts of the world where those in greatest need have no access to banks, and charitable activity generally in regions where the banking system is corrupt or otherwise unavailable.<sup>4</sup> Guidelines for accountability in situations of this kind would be welcome.

**Anti-Terrorist Financing Procedures.** In this section of the Voluntary Guidelines, Treasury urges charities to collect "basic information" about potential foreign grantees, "conduct basic vetting" of potential foreign grantees, and "review the financial operations" of those organizations. What Treasury calls "basic" is, in some instances, extraordinarily detailed.

According to the Voluntary Guidelines, a charity should collect the following *basic information* about a foreign grantee: its name (in English and in its own language, together with acronyms or other names it is known by); the country where it "maintains a physical presence"; the country in which it is incorporated or formed; the address and phone number of "any place of business" of the grantee; and the grantee's principal purpose, "including a detailed report of the recipient's projects and goals." The charity should also gather information on the grantee's existing sources of income. In addition, the charity should obtain:

- ❑ "the names and addresses of organizations to which the foreign recipient organization currently provides or proposes to provide funding, services, or material support, to the extent known, as applicable
- ❑ the names and addresses of any subcontracting organizations utilized by the foreign recipient organization

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<sup>4</sup> In the November 12, 2002, issue of the *Wall Street Journal* at page A4, the article "Afghan Aid Flows Through Dark Channels: U.S. Is Forced to Move Funds in Money-Transfer Networks Used by Terror Groups" reports that CARE, World Vision International, and similarly distinguished organizations use "hawalas," traditional money changers, to deliver aid funds in Afghanistan and Pakistan and that the U.S. government accepts this procedure as necessary under the circumstances because there is no functional banking system and, thus, no alternative.

- ❑ copies of any public filings or releases made by the foreign recipient organization, including most recent official registry documents, annual reports, and annual filing with the pertinent government, as applicable.”

*Basic vetting*, according to the Voluntary Guidelines, consists of four steps, all of which should be documented. First, the charity should “conduct a reasonable search of public information, including information available via the internet,” to determine whether the potential grantee “is or has been implicated in any questionable activity.” (The Guidelines do not define what activity is deemed questionable for this purpose.) Second, the charity should verify that the potential grantee is not identified on any list of the U.S. government, the United Nations, or the European Union as “having links to terrorism or money laundering.” The Guidelines refer to specific lists where charities may obtain this information.

The third step under the Voluntary Guidelines is worth quoting in full, as it states a due diligence standard that significantly exceeds the current practices of most international grantmaking charities in the U.S.:

The charity should obtain the full name in English, in the language of origin, and any acronym or other names used, as well as nationality, citizenship, current country of residence, place and date of birth for key staff at the foreign recipient organization’s principal place of business, such as board members, etc., and for senior employees at the recipient’s other locations. The charity should run the names through public databases and compare them to the lists noted above.

Finally, the Voluntary Guidelines state that the grantor charity should require foreign grantees to certify that they neither employ nor deal with any persons or organizations on the lists noted above, “or with any entities or individuals known to the foreign recipient organization to support terrorism.”

The *financial review* contemplated by the Voluntary Guidelines for grants to foreign organizations is also spelled out in detail. The Voluntary Guidelines expect the charity to gather extensive information about the financial institutions with which the foreign grantee has accounts, so that it can determine whether those institutions are operating under offshore licenses, licensed in money-laundering jurisdictions, or licensed in jurisdictions that “lack adequate anti-money laundering controls and regulatory oversight.” The charity should impose on its grantee the obligation to take reasonable steps to ensure that grant funds “are not ultimately distributed to terrorist organizations” and to report periodically on its compliance with this obligation. The charity should require periodic reports on its grantee’s use of funds and, “consistent with the size of the disbursement and the cost of the audit,” perform on-site audits of foreign grantees “whenever possible.”

*Comments.* This section of the Voluntary Guidelines is apparently based in part on the USA Patriot Act, particularly with regard to checking grantee organizations and their affiliates against the lists of organizations designed by various governments as terrorist-affiliated. Other elements of this section, however, go far beyond the law. By our count, less than half of the 47 so-called “best practices” are required by existing federal and California law.

The Voluntary Guidelines, as written, would establish this level of inquiry as a best practice for all cross-border grants, regardless of whether the facts and circumstances indicate the possibility that the grantee or related parties may be involved, directly or indirectly, in terrorist activities or the broader and undefined range of “questionable activities.” This creates a burden that is likely to discourage much cross-border giving, even where there is no indication of terrorist financing.

**Conclusion.** Our critique of the Voluntary Guidelines would not be complete without recognizing that they also deserve respect as an early national response to 9/11 with the goal of increasing national security. As internationally recognized U.S. charitable institutions, with direct funding from the government as well as funding from contracts with various governmental agencies, [redacted] will want to review their current practices in light of the Guidelines and determine how those practices should be modified or supplemented in line with Treasury's goals. [redacted] in addition, may want to consider the opportunity this presents to take a leadership role in demonstrating to other international grantmakers how compliance might be tracked and improved.

According, we are preparing a detailed Voluntary Guidelines Compliance Analysis of current due diligence procedures and practices of [redacted], identifying which Guidelines are required under federal or California law, which Guidelines reflect current practices of [redacted], and which additional Guidelines we recommend be followed. Because an accurate analysis of current practices will require the joint efforts of legal counsel and [redacted], we will send to you an initial discussion draft of the Analysis for your review and revision. We recommend that the Voluntary Guidelines Compliance Analysis be treated as the legal equivalent of a financial audit and that consideration be given to conducting such an Analysis on an annual or other periodic basis.